AQR: NEW ERA NEW LEADERS

by Daniel P. Collins

For years folks in the managed futures space have looked for a way to expand into the broader investment universe. That day has arrived.

Applied Quantitative Research (AQR) was founded in 1998 by Clifford S. Asness, David G. Kabiller, Robert J. Krail and John M. Liew.

Asness, Liew and Krail met at the University of Chicago where the foundation of what would become AQR was established. They would go on to lead a quantitative research team at Goldman Sachs before striking out on their own.

AQR was among the first hedge-fund managers to voluntarily register at its inception with the Securities and Exchange Commission (SEC). The first AQR product was a hedge fund, but the goal was always to expand into traditional portfolio management, which it would later do. In 2009, AQR became one of the first investment managers to offer alternative strategies in a mutual fund format and expanded to managed futures.

The groundwork was laid when they sought SEC registration at a time when most hedge funds were avoiding the SEC any way they could. AQR has become the leading name in managed futures mutual funds, accounting for nearly half of the managed futures 40-Act Fund market share (see "Leading the pack," right).

"We opened with the idea of having regulators look over what we are doing. That was a choice we made largely because we felt confident in our operation and think it appealed to institutional investors to have regulatory oversight," says Brian Hurst, principal and portfolio manager for two AQR global macro funds.

We talked to AQR Principals Hurst and Yao Hua Ooi about AQR's managed futures products and the ascendency of the 40-Act mutual fund as the structure to deliver this asset class.

AQR's managed futures products mirror the main strategy in the space — trend following. "They are strategies that take advantage of the observation that most financial markets tend to exhibit trends," Ooi says.

AQR offers two medium- to long-term trend-following programs; one targeting volatility of 10% and the other 15%. They are offered through managed accounts as well as 40-Act structures in the United States and UCITs structures globally.

They trade four major sectors: Equity indexes, currencies, fixed income and commodities. The strategies allocate equally to those four sectors.

"When you look at funds labeled as managed futures many of them do not just do trend following. Many of them — especially larger funds during the last few years — have morphed into trend-following plus other investment strategies," Ooi says, when asked what differentiates AQR's funds. "One of the points of differentiation is that our strategy is focused on trend following because we believe that trend following is the investment style that provides the most reliable benefit to portfolios during large equity market drawdowns, which is the predominant risk for many investors."

It is most likely the performance of managed futures in 2008 — especially vs. equities and equity-based hedge funds that proved to be more correlated to the market than advertised — that got the broader investment universe interested in managed futures in general and trend following in particular. However, that universe was weary of futures in general and the private placement structures — commodity trading advisors — that they were mainly offered through.

"As far as the timing on the 40-Act business, I don't think we actually knew that liquid alts were going to take off when we did it; we did know that investors needed access to diversifying products in their portfolios," Hurst says.

It was at that point that the idea of offering managed futures through the 40-Act structure gained steam. AQR had a head start because they already had those structures in place. AQR originally offered managed futures through a multi-strategy fund in 2008, would launch a standalone limited partnership in 2009 and launched the 40-Act fund in early 2010.

Unfortunately, this was the beginning of one of the worst performance periods for the asset class. The Barclay CTA Index only had three negative years from 1980 through 2008. Four of the next five years produced negative performance for the index, including three consecutive years from 2011 to 2013 (see "Managed futures from the beginning," right).

The timing in 2009, when they launched mutual funds was not great. "People thought the world was ending," Hurst says. "We still had enough confidence to launch this because we knew there was going to be a need from individual investors to diversify their portfolios beyond stocks and bonds. You can't build a diversified portfolio with just stocks and bonds."

Ooi adds, "It was clear that managed futures was much more diversifying from equities than most other strategies. One of the first papers AQR published was 'Do hedge funds hedge?' We have been out there for a long time talking about how most people who implement hedge fund strategies aren't hedged enough, that they are too correlated to the market. When we implement a strategy, whether it is managed futures or any one of our other strategies, we really focus on trying to be market-neutral in implementing the strategy."

In retrospect that may have given AQR a head start as demand for alternatives tend to fade in robust bull markets like what we've had since 2009.

Despite the environment, the AQR Managed Futures Strategy has done well, producing an annualized return of 4.02% during the last five years, which was an extremely difficult period for trend following. It is one of only three funds in the sector earning a five-star rating by Morningstar.

Opposed to many strategies in the managed futures space, AQR does not attempt to add models in addition to trend following. While not attempting to create a beta index, AQR's Hurst says it sticks to its trend-following knitting.

"There are two aspects to make something a beta," Hurst says. "The first is that it is something that is well known. The second, is that everyone agrees on a precise definition of what it is. In the case of managed futures, it acts like a beta because it

LEADING THE PACK

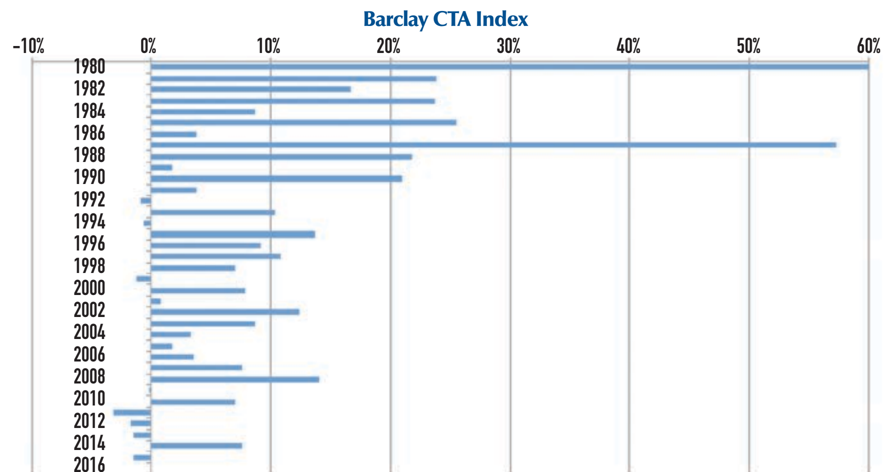
AQR funds account for a great deal of the managed futures 40-Act Fund market shares. Its main fund has triple the assets of the next largest fund.

Name	Ticker	Inception Date	YTD return	2015 return	Fund Size
AQR Managed Futures Strategy I	AQMIX	Jan. 6, 2010	0.393	1.997	11,022,644,400
Natixis ASG Managed Futures Strategy A	AMFAX	Jul. 30, 2010	6.365	−1.382	3,309,387,266
Catalyst Hedged Futures Strategy A	HFXAX	Dec. 15, 2005	0.736	7.808	2,896,224,764
LoCorr Market Trend A	LOTAX	Jul. 2, 2010	−0.833	5.679	1,341,972,395
Equinox Campbell Strategy A	EBSAX	Mar. 1, 2013	−0.274	−3.825	1,176,532,334
361 Managed Futures Strategy I	AMFZX	Dec. 20, 2011	0.000	−0.358	740,683,973
JNL/AQR Managed Futures Strategy B		Aug. 11, 2009	0.412	2.320	690,993,506
Abbey Capital Futures Strategy I	ABYIX	7/1/14	0.414	4.119	637,634,483
AQR Managed Futures Strategy HV I	QMHIX	7/16/13	0.187	2.484	615,187,411
LoCorr Managed Futures Strategy A	LFMAX	3/22/11	6.909	3.266	606,301,644
Altegris Futures Evolution Strategy A	EVOAX	10/31/11	3.309	3.053	555,185,173
Longboard Managed Futures Strategy I	WAVIX	6/27/12	−4.660	8.908	552,657,058
American Beacon AHL Mgd Futs Strat A	AHLAX	8/19/14	4.561	−1.545	463,879,314
Equinox IPM Systematic Macro I	EQIPX	7/6/15	10.313		462,871,138
PIMCO TRENDS Managed Futures Strat A	PQTAX	12/31/13	6.870	−9.587	347,989,759
Equinox MutualHedge Futures Strategy A	MHFAX	12/31/09	6.444	2.813	289,081,934
Aspen Managed Futures Strategy A	MFBPX	8/2/11	−1.119	−2.755	283,514,004
Transamerica Managed Futures Strategy I2		9/30/10	0.225	1.717	274,452,812
Altegris Managed Futures Strategy A	MFTAX	8/26/10	4.628	0.489	223,481,958
Guggenheim Managed Futures Strategy A	RYMTX	3/2/07	−3.318	−1.063	189,419,097

Source: Morningstar

MANAGED FUTURES FROM THE BEGINNING

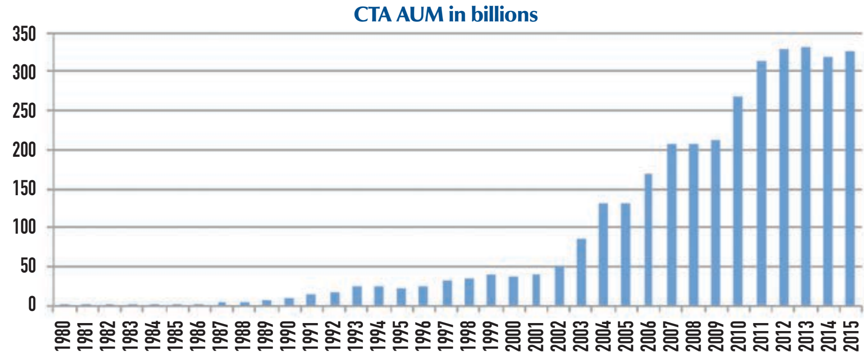
Performance of Barclay CTA Index since its creation.



Source: BarclayHedge

AUM IN FOCUS

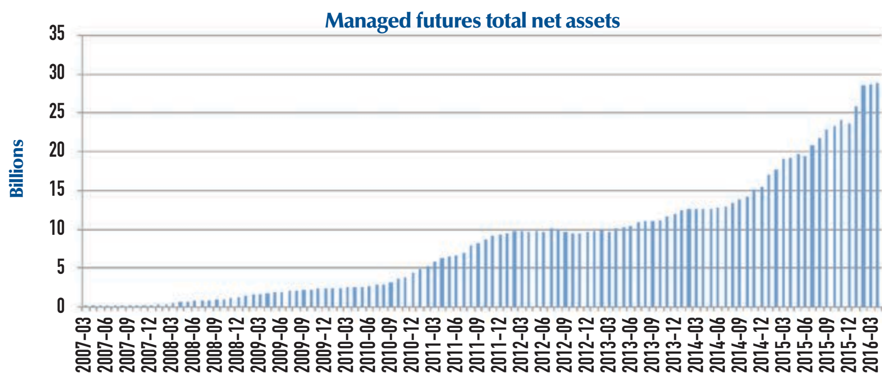
Assets under management for CTAs has dropped from their peak and the overall growth has slowed.



Source: BarclayHedge

GROWING DEMAND

Size of the managed futures mutual fund space.



Source: Morningstar

is well known. But, when it comes to implementing the idea, there are thousands of different parameters, different ways of constructing portfolios, different trading rules, and so not everyone agrees with one precise definition. For that reason, we think it provides diversifying alpha."

The issue of beta is a bit complicated. In the broad investment universe, allocators love to have ways to measure a manager's performance versus a specific benchmark. While that is easy to do with long-only equity hedge funds attempting to outperform the S&P 500, it is much more difficult when measuring a style. And despite the adherence to correlation models, as Hurst noted, trend following provides broad return streams based on holding periods, positon weightings across upwards of 60 or more markets and risk management strategies. However, in the end, traders end up in the same trends — when there are trends — so correlation metrics can be deceiving.

"No one can agree on a [benchmark]," Hurst says. "We think that we are a differentiator in the space. The difference comes down to improvements in portfolio construction and diversification and a very big focus on execution. We put a lot of money and effort into customized execution algorithms."

Execution

With a total of $18 billion allocated to various managed futures based funds, execution models are key to AQR's success.

There was a time in the managed futures space when $1 billion in assets under management was viewed as a sort of sound barrier. The larger a fund becomes, the more difficult it is to maintain performance. Especially when trying to maintain a diversified allocation to commodity markets.

"When we launched our first multi-strategy hedge fund, we cut subscriptions by 50% just to be conservative on capacity," Hurst says. "After we launched and were trading in the portfolios regularly, we realized we were fine and could accept more."

He also points out that total assets in the space have actually fallen (see " AUM in focus," left). "As a strategy, trend following is nowhere near capacity. But each individual manager has to optimize their own execution," Hurst says. "That is why as we have grown, we have poured more and more assets into building customized implementation methods. That is a big focus of our current research."

Ooi acknowledges that that capacity is a concern but adds, "We don't think we are close to it. Today, we have $18 billion in managed futures assets and we are not up against any immediate capacity concerns; we still think there is decent room to grow, but we do acknowledge that there is finite capacity for any manager."

Many managers will freeze allocation to outside customers when they approach a potential capacity area until they see how the fund handles that size and they can alter entry algorithms. Ooi says AQR will take the same approach but notes that they are nowhere near capacity. They estimate the capacity in their trend-following funds to be between $25 billion and $35 billion. Currently their main trend following fund is north of $11 billion.

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— Yao Hua Ooi

Distribution

An advantage of offering managed futures through a 40-Act mutual fund is the large distribution network already in place. CTAs offering managed accounts target high-net-worth investors and family offices, which are fewer than the universe of registered investment advisors. Even with the institutional pension world being more open to allocating to managed futures, private placements have more restrictions.

"We have very high minimums because we like to deal with registered investment advisors, and the large platform with significant research capacity," Hurst says. "It is not stocks and bonds. We do like the idea of having professionals who we can educate on the strategy and they can take the time to educate their individual clients."

Ooi adds, "By and large people in the funds are investing through RIA, wire houses [and] independent broker dealer platforms."

No one can invest directly in AQR's funds without $1 million. Fees for institutional share classes run 1.25%. This puts AQR at an advantage over the typical CTA structure charging a 2% management fee and a 20% incentive fee. "Our fees are very competitive, 1.25% institutional share class fee is very competitive, there are no performance fees tied to that structure," Ooi says. "Relative to a traditional CTA that also tends to have some intermediary involved, the bulk of investors who access the strategy through our funds probably are paying a lower fee overall."

This puts AQR at an advantage over other 40-Act fund firms that are providing access to other CTA programs that must extract their fees. Some use a swap structure that imbeds the manager fees before charging the management fee of the fund. By being the manager underlying the fund, AQR does not have that layer of fees.

"There is a structural advantage in that we are running the strategy ourselves," Hurst says. "A lot of the competing products are effectively fund of funds where the manager is charging a fee on top of the underlying CTA fees. There is a structural cost advantage with our vehicle that investors recognize."

The strategies are the same but the structure is more accessible to certain investors. "We are offering an investment strategy and there are different wrappers for that strategy. The 40-Act structure is one wrapper, a Cayman Limited partnership is a wrapper and they are serving different investor bases," Hurst adds. "There is a huge class of investors who can only consume products in a 40-Act wrapper."

Fear of futures

It is not only the structure but a long reputation of futures being a risk asset class that AQR had to overcome.

"People are scared of things they don't understand so we have put forth a lot of effort and resources into trying to make the whole hedge fund industry — and all the different strategies within the hedge fund universe, including managed futures — more transparent," Hurst says. "We try to explain to investors what is going on in their portfolios — once you do that they start to understand it better and they get more comfortable."

The fee structure has proven to be an advantage. "You have to offer it at a fair fee," he adds. "You can't charge so much that at the end of the day the investor doesn't have anything left over. That has been our approach: Educate and offer products at fair fees. That has been what a lot of investors have latched onto."

Trend following itself has long been suspect to the folks who believe in the efficient market hypothesis so a large educational effort was necessary. "An important component of our education is publishing research We have really tried to make the strategy much more understandable and transparent to investors or researchers.

By doing that we have enabled people who were not comfortable with the strategy, who perhaps perceived it too much as a black box technical strategy, to better understand [it]," Ooi says. "For example, what is in the strategy? How does it actually work? What are the historical attributes of the strategy? Under what conditions should it do well or poorly? How has it done historically in different environments? By doing a lot of this research, we have been able to position managed futures in a different light."

And it is not just investors and institutional allocators that need to learn. There still is resistance from regulators, which many suspect are behind the current 18f-4 proposal by the SEC that could make allocating to 40-Act mutual Funds that utilize derivatives, more difficult, if not impossible. The rule limits funds' exposure to derivatives to 150% of their notional value.

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"The main concern is that it is overly penalizing the use of low-risk derivatives specifically fixed income and currency derivatives, because it caps gross notional exposure, which isn't — as the SEC acknowledges — the best metric for risk," Ooi says.

Both Ooi and Hurst express support for the broader goals of the SEC to suppress "over-speculation" and getting people on the same page, and while it is not good policy to talk down your regulator, AQR obviously have problems with the rules.

"The reality of that is the vast majority of liquid alt strategies — managed futures and others — have less risk than the S&P 500 Index. And that is obviously a risk level regulators and individual investors are comfortable with," Ooi says.

Hurst does not believe, as others do, that the rule as it is written would kill the product.

"People are going to have a demand for diversifying products. Managed futures is one of them regardless of how the rule ends up panning out. There are solutions to offer investors attractive risk-adjusted returns in managed futures strategies or any other strategy we offer," Hurst says. "It doesn't mean you can't change the program and achieve the goals of the investor. I would be very surprised if anyone shuts down because of the rule."

Hurst doesn't see it coming to that. "We will have a solution. Moreover, it is very unlikely there are going to be no changes to the proposed rule. Many of the comment letters suggested the need to risk-adjust the notional limits," he says. "Many regulators know very well exactly what the issues are."

You can have my CTA when you pry it …

While the SEC proposal represents a real threat, they will be hard pressed to approve the rule without significant changes. More pension funds are seeking diversification from what many analysts see as a shaky stock market. Morningstar reported that managed futures mutual funds saw an inflow of $1.5 billion in January (see "Growing demand," page 24). And *Pensions & Investments* reported that the California State Teachers Retirement System (CalSTRS) recently announced it would be allocating $16 billion to "risk mitigating strategies," 40% of which would be dedicated to trend-following strategies.

"That is not a new trend, it has been happening since 2008. Plans have been de-risking from equities since then," Hurst says. "They have been looking for other ways to hit their return targets without being so loaded with one type of risk, which is the equity risk. A good portion of their portfolios is in fixed income and given where yields are today, people are looking at higher returning investments that are not equities."

While the allocation by pension funds is not new, labeling the use of trend following as "risk mitigation strategies" makes it more difficult for regulators to restrict their access as being overly speculative. And what would happen when (and the question is "when," not "if") there is another year like 2008 and America's overburdened pension system suffers another hit without access to strategies that have proven to provide positive returns during large equity drawdowns? It would be hard to explain.

Hurst adds, "There are some investors who are not set-up structurally to invest in private vehicles. That is why I don't think these things are going away. There is a need for investors to have something other than stocks and bonds to hit their retirement goals."

There does appear to be momentum building for these products and AQR seemed to have broken a barrier that will be difficult to undue.

"I do think our efforts at educating has helped in understanding how the strategy works inside a portfolio and helps take the focus away from the last few years of performance and really makes the conversation about the long-term expectation for the strategy and what kind of impact you can expect it to have over many different market cycles," Ooi says. "That is a healthy development and it helps explains the CalSTRS move and other pensions that are following suit." ∆