Cliff Asness: A hedge fund genius goes retail
Shawn Tully

He already manages billions for elite investors. Now Cliff Asness believes he's perfected a better way for regular folks to play the market, and he's using that formula to build a mutual fund empire.

PHOTO: GILLIAN LAUB

FORTUNE - Even among hedge fund brainiacs, Cliff Asness qualifies as a high achiever. In just 13 years Asness has built his firm, AQR Capital, into one of the industry's half-dozen biggest players, with $42 billion in assets under management. Leading a team of 29 Ph.D.s at AQR's elegant offices in Greenwich, Conn., he runs the equivalent of an ultra-advanced research lab for financial products. Asness, 45, is a Ph.D. himself who narrowly chose managing money over a professorship and remains influential in academic circles. That's the elixir for his success. When he designs a market-beating strategy, his data are so convincing that he gets the research community overwhelmingly on his side. The sway of his science gives him just the right pitch to keep gathering assets from America's big institutional investors.

But Asness isn't content just to expand his hedge fund kingdom and burnish his standing in academia. He has recently begun moving into an area where hedge fund wizards have seldom ventured and where, at least for today, most have no desire to go: mutual funds. Asness is now offering sophisticated strategies to the broad public that for years have been available only to institutional clients.

His move into mutual funds could reshape the investing world in two important ways. First, it might well spawn a wave of imitators. AQR already offers a suite of nine mutual funds that have attracted a substantial $5.5 billion in assets. The products are proving so attractive to financial advisers that other hedgies are sure to recognize the potential in providing hedge-fund-style products to America's 401(k) crowd. (One other large hedge fund to enter the arena thus far is Highbridge Capital, a unit of J.P. Morgan Chase (JPM), which now runs seven mutual funds.) "We're almost certain to offer the AQR mutual funds and recommend them to our clients," says Larry Swedroe, director of research for Buckingham Asset Management, an advisory firm in St. Louis that manages $3.5 billion. "They're bringing sophisticated strategies to retail investors at reasonable prices. We're convinced by the science."

Second, by offering mutual funds at far lower costs than institutions pay for hedge funds, AQR could force its hedge fund rivals to substantially reduce the exorbitant fees -- the traditional "2 and 20" - they charge institutions. "Pension funds and the like will start asking, 'If mere mortals are getting the same product at low fees through mutual funds, why are we paying a big premium?" says Jeff Colin, a co-founder of Baker Street Advisors, a $4 billion investment firm in San Francisco that uses AQR's mutual funds.

So why, exactly, is Asness messing with his chosen industry's golden formula? His motivation, he admits, is partly to make AQR far bigger -- and in the process increase his own substantial net worth -- by amassing tens of billions of dollars in additional assets. But the bearded, burly Asness also has a subversive side and says he relishes the idea of challenging his peers on fees. In fact, he already has. Of the 50 or so funds that AQR runs, just a couple charge investors 2% of assets and 20% of profits. Most of AQR's hedge funds charge 1% and 10%.

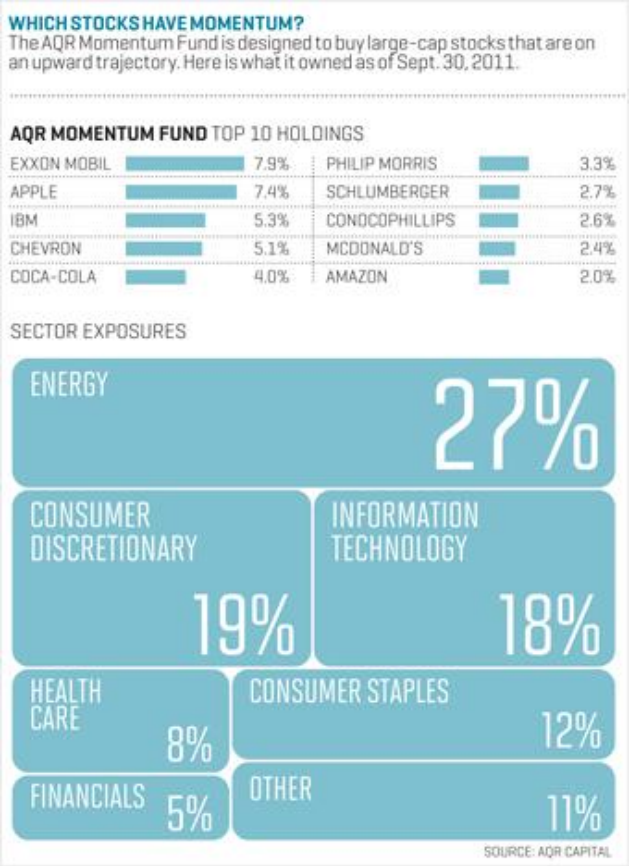
"Hedge funds charge far too much in general by claiming to be geniuses," says Asness, lounging on a sofa in his corner office, surrounded by foot-high plastic models of comic book heroes like Captain America and Spider-Man. "Getting into mutual funds certainly isn't altruism - it may be greed - but it makes the world a better place."

He also sees an irresistible opportunity in mutual funds to popularize an idea that he's been championing for nearly two decades: momentum investing. Back in the '90s tech boom, there was a lot of talk about harnessing market momentum. This is different. What Asness uses is a very specific methodology that's so far unfamiliar to most investors. He believes that momentum deserves to be the next big thing in money management, and it's his pet strategy for good reason. Asness was among the first academics to discover the momentum phenomenon in his 1994 Ph.D. thesis at the University of Chicago and has deployed it in his institutional funds, with outstanding results, for well over a decade. The momentum approach is a powerful idea based on common sense and strongly supported by the data: Stocks that have done well recently will keep doing well for short periods. Asness's contribution is to package this concept into a marketable product -- in part by holding down fees.

The reason Asness thinks that momentum will have enormous popular appeal is basic but compelling. In the right mix, he says, it can add substantially to an equity portfolio's return without increasing risk. And right now, the added juice from momentum is especially valuable, given Asness's view that stocks are still a bit on the expensive side and that market gains in coming years will be below the long-term average. He expects stocks to return around 7% a year. As we'll see, there's reason to believe that momentum can give that number a modest boost that adds up enormously over time.

The birth of applied quantitative research

Asness first shook up the finance world in 1995 when, at age 29, he founded the Global Alpha fund at Goldman Sachs (GS). Global Alpha was one of the earliest "quant vehicles," and one of the most influential hedge funds ever. The idea behind it was to produce outstanding returns no matter how the stock market performed. Asness and his team used powerful computerized trading models to scour the globe not just for underpriced equities and bonds but also for cheap currencies and commodities, and deployed leverage and short-selling, combined with big doses of a momentum. In just three years at Goldman, the assets managed by his group swelled from $100 million to $7 billion. Global Alpha's success spawned a new wave of quant funds.



In 1998, Asness formed AQR (the initials stand for "applied quantitative research") with three of his fellow managers from Goldman. After a decade of spectacular results, AQR got hammered in the crash of 2008. Its assets dropped from $39 billion in 2007 to $17 billion by the end of 2008. "We were looking the grim reaper in the face," recalls Asness. He and his partners visited investors to explain what had happened in person, a strategy that stemmed the huge redemptions that sank so many competing funds. "We'd been very consistent over the years saying that certain funds had high volatility, and that the historical data showed that," says Asness. "So when it actually happened, they understood you can suffer these kinds of short-term shocks and still have excellent long-term results."

Indeed, AQR's returns were quick to rebound. A good example is the record of its flagship Absolute Return Fund, the successor to Global Alpha. Numbers obtained by *Fortune* show that over the past 16 years the Absolute Return strategy has produced annual gains of 10.8% after fees, including the results of Global Alpha from the three years Asness ran it using the same approach. That compares with 6.8% for the S&P 500 (SPX). By contrast, Goldman's Global Alpha fund performed so dismally in recent years, shrinking from $11 billion in assets at its peak to $1 billion, that it was closed down in September.

AQR launched its family of mutual funds in 2009. The roster includes funds that employ merger arbitrage strategies, buying shares of takeover targets and profiting if and when the deals close, and others that apply classic long-short hedging. Three funds are dedicated to the momentum approach: AQR Momentum, AQR Small Cap Momentum, and AQR International Momentum. (The funds are sold through fee-only financial advisers.)

To understand how Asness implements his strategy, let's examine AQR Momentum, which focuses on large-cap stocks. In building the portfolio, AQR screens the 1,000 largest U.S. stocks by market capitalization and buys the 33% that have performed the best over the past 12 months. The fund "rebalances" every three months, generally selling stocks that did the worst in the most recent period, and adding new winners. It's a simple formula (though its optimal execution requires Ph.D.-level algorithms). But the numbers show that it works.

Indeed, AQR's research is so convincing it's persuaded almost the entire academic community. It has even won over an influential figure who is inclined to be skeptical: Eugene Fama, the famed efficient-markets guru and Asness's thesis adviser at the University of Chicago. "The data show it does well just about everywhere," says Fama. "The evidence that it produces superior returns over long periods, if you can do it cheaply enough, is robust."

Since the AQR funds are only a couple of years old, the case for momentum rests on "back testing," using the results culled from choosing stocks with the same criteria AQR uses now to replicate past returns. According to AQR's research, large-cap momentum stocks averaged annual gains of 12.6% from 1980 to 2011, vs. 10.8% for its benchmark, the Russell 1000 index of large-cap stocks. Asness says that testing all the way back to 1928 shows an even stronger edge over the index. It's especially useful to measure momentum against the performance of the two major types of equities: growth and value, or "expensive" (high price-to-book) and "cheap" (low price-to-book) stocks. Since 1980 the momentum strategy would have outgained growth by 2.7 percentage points annually, 12.6% to 9.9%. More impressively, it also defeated value -- long considered by academics to be the most reliable strategy for outperforming the market -- by an average of 1.3 points per year.

Ironically, no one is absolutely sure why the momentum effect exists -- only that it does. The proof is in the data, not the logic. But the best theory, embraced by Asness, is that investors have a delayed reaction to both good and bad news about companies. "It's really adding the influence of animal spirits to efficient markets," says Asness. The idea is that when a company posts a surprise jump in earnings or profits, say, and it really deserves a 10% boost, investors go only halfway at first, raising the price 5%. Over the next few months the stock will begin to move closer to its fair value. "Then, at the end of the process, you get the bandwagon effect," says Asness. "Stocks tend to go well past fair value and reverse." The key is to buy when a stock is still gathering momentum, and exit before it falls again.

According to Asness, the highest and best use of momentum is to blend it 50-50 in a portfolio with the other high-octane category: value. "Momentum is good on its own, but it's amazing when you add it to value," he says enthusiastically. AQR's back-testing shows that combining the two should produce exceptional returns with far fewer losing streaks than either value or momentum display on their own. It's been a pillar of finance theory for over 30 years that value stocks far outperform growth stocks in the long term. The problem with value is that it

goes through horrible periods, as when it fared 29 percentage points worse than the market during the tech bubble. Though it's a long-term winner, momentum encounters similarly rocky periods. But together, they are tough to beat.

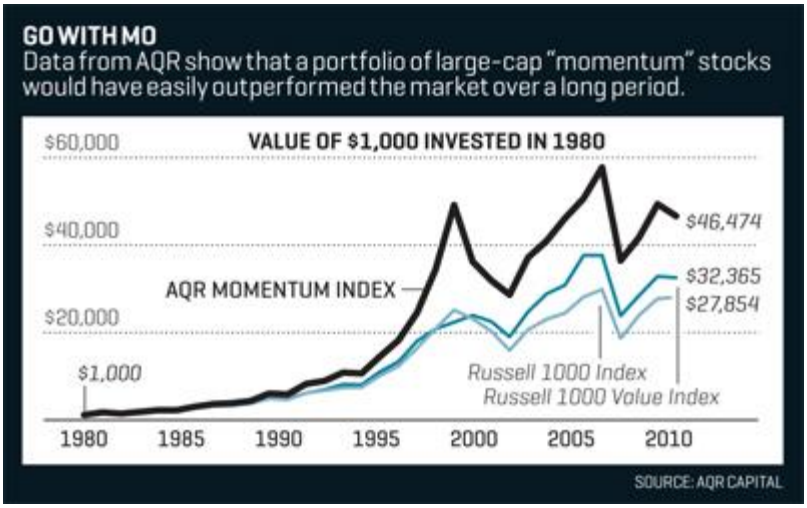
Here's how momentum and value complement each other. From 1980 until today, what we'll call the V plus M portfolio returned 12.2% a year. That's just a bit less than M on its own, and 90 basis points better than value. But the combination's biggest advantage rests in how each side steadies the other's jumpy tendencies. Over our time horizon, the V plus M portfolio beat the Russell 1000 in 25 of 32 years, or 78% of the time. By contrast, value alone outperformed in just 53% of those years. In all but nine years, one beat the market while the other lagged.

Asness and his partners emphasize that momentum plus value in a portfolio easily beats the traditional pairing of value stocks and growth stocks. The reason? Momentum buys only improving stocks. By definition, growth stocks rise a lot over time. But those stocks eventually become expensive. The momentum approach catches many of them on the way up, when they're getting pricey but before they get way overvalued. What about the real highfliers, the ones with big price-to-earnings multiples that are extremely vulnerable to a sharp drop? Momentum buys those too. But so long as they don't drop too suddenly, momentum will still do well.

When value doesn't pick up the slack

As compelling as the case for momentum investing may be on paper, Asness must deal with one inconvenient fact as he markets his funds: Lately the strategy just hasn't done very well. All three of AQR's momentum funds have underperformed the market since their launch in 2009. The large-cap AQR Momentum, for instance, is up 34% since inception, vs. a 43% gain in the Russell 1000 index over the same period. If that bothers Asness, he doesn't show it. He argues convincingly that even the best investment strategies suffer convulsions that are impossible to forecast, and that momentum's long-term success is certain, if investors will hold tight.

Nevertheless, even the Ph.D.s at AQR are astounded by the abysmal performance of the V plus M combination over the past few volatile years. Here's how they explain what happened, using the example of large-cap stocks. As the market swooned in 2008 and early 2009, the momentum strategy loaded up on defensive names such as Exxon (XOM) and Wal-Mart (WMT), which performed better than the average stock during the crash. Momentum shunned financials such as Bank of America (BAC) and J.P. Morgan, which were falling sharply. But in the explosive second quarter of 2009 the financials jumped 30%, waxing the Russell 1000's gain of 16%. Exxon and Wal-Mart, the large-cap momentum portfolio's two biggest holdings, did poorly, with the energy producer rising just 3% and the retailer falling 7%. The reversal was so sudden that the fund got stuck with underperforming stocks for a couple of months and missed out on much of the upside in the fastest-rising sectors.



This time, value didn't make up the difference, or even come close. For the first time in three decades, it grossly lagged the market at the same time as momentum. The combination did well in 2010 but is lagging again in 2011. The pairing of value and momentum has trailed the benchmark Russell 1000 through November by three points, losing 2.3% vs. the Russell's gain of less than 1%.

Over the long haul, the odds are that markets will normalize and the momentum approach will return to beating the averages. But even assuming that's true, holding down fees and trading costs is crucial to making it viable for regular investors, as Asness knows well. For the large-cap AQR Momentum Fund, Asness charges a management fee of just 0.49% (and no load). That's a bit more than most index funds, but far less than the 1.3% for the average actively managed option. Aren't his institutional clients annoyed that mutual fund investors can get access to his services for a fraction of the cost of a hedge fund? No, says Asness. In fact, he says he charges as little as 0.5% of assets for simpler hedge fund strategies that are similar to the momentum mutual funds.

Trading costs are potentially a major problem for momentum funds. Because of the quarterly rebalancing, AQR's portfolios turn over 1.5 times a year. All that trading could get expensive. But AQR holds down costs by running its own trading desk and using proprietary algorithmic models that allow it to avoid trading through Wall Street firms. Asness estimates that trading costs run about 0.7% a year. So total expenses for an AQR momentum fund -- fees plus trading -- are around 1.2%.

But remember: That's just half of the portfolio. Asness recommends that investors combine his momentum fund with a low-cost value index fund. A favorite of his is the DFA U.S. Large Cap Value from Dimensional Fund Advisors (DFLVX), another shop with lots of academic weight. It has a fee of just 0.28%. After expenses, a portfolio that blends AQR Momentum and the DFA value fund should give investors a net extra return of around one percentage point a year, according to AQR's projections. Stick with that strategy, and your nest egg will be 35% higher in 30 years than if you buy the market as a whole.

By then, Asness hopes that momentum will be long established as a superior investment strategy, and that AQR will have reaped the benefits. "When you're right, you want to be a survivor to prove it," says Asness. "You want your company to be around to see your theory working 20 years from now." Back-testing is well and good. But starting now, his big idea will be judged in the market.

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