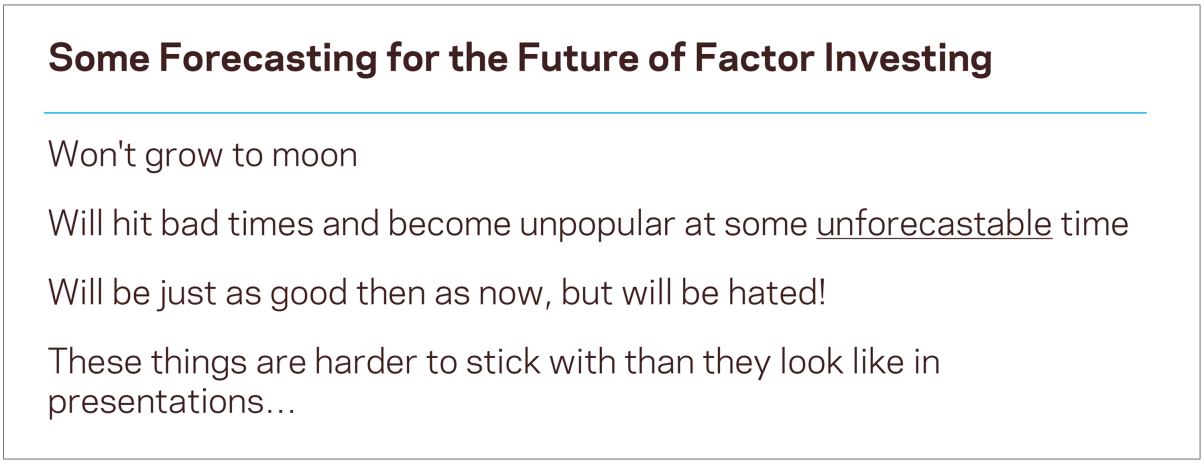
Perspectives

Quant Cassandra [1]

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Below you will find a page from one of my standard presentations for the few years before this dreadful last year and change.[2] I had forgotten about this until a recent client meeting. The page was created to address the then common question, "what does the future of quantitative (or factor) investing look like?" The implication behind this common question was almost all positive back then. It's going great. It makes sense. When does it take over the world? How big and important can it get? So, complete with the actual font used at the time, here's the exact page I spoke to answering this inquiry:



I, and AQR, have very little to brag about over the last year and change, especially when it comes to most of our individual equity strategies (defensive equity, global macro and a few other niche strategies have been nice, but mostly it's a tale of woe for our equity strategies and for a lot, though certainly not all, of our clients' experiences). And, while I will be shamelessly bragging about the above prognostications, I also have to admit it wasn't even great insight at the time. It was all very obvious and I'm certainly not the only one to have said similar things. But "obvious" is often a long way from "really believed and internalized" and in the gap between those two fortunes are made and lost.

So, while, again, not a particularly impressive feat on my part, I do have to immodestly note the accuracy of each bullet point. Sixteen months ago (approximately when things got rough for us – not 8-10 years of pain like people discuss for simple value investing, though some days it feels like it) we were closing strategies due to excess demand (and some of you were mad at us for that – you know who you are!). Back then, and for quite some time, I said we couldn't forecast when tough times would hit but they absolutely would hit. I said that I believed our strategies would be just as good after that experience as before. While I hope my forecast that they'd then be "hated" was a bit extreme on my part, I think I got that directionally right too. Most important was the last line. Despite our shared belief in these ideas (or else why were we doing them together?), we knew (for quite a while and before any tough times hit) that sticking with them through the inevitable painful periods, which always seem to be at the outer edge of what you might have guessed possible, would be much harder than it should be in a world of cold scientific automatons.

These strategies, in my humble opinion of course, can be great long-term additions to many portfolios. But they do go through unforecastable[3] bad times, like most real-life strategies do. And those times are way, way tougher to stick with than anyone thinks ex ante. Even I'm finding it tougher than I would've forecast and I'm the guy who created the page above telling everyone it would be super tough! [4]

When I am discussing my colleagues' superb paper Buffett's Alpha, as I often am, I start by reassuring my listeners that our authors don't really think Buffett is a closet quant. But, rather, they show that quant themes like value, profitability, and low risk clearly show up in his returns (correlation with quant ideas does not mean he's been up at night learning Python). In fact, we consider it rather impressive that the things he talks about, not just looking for cheap companies but cheap, consistently profitable, safe companies, seem to be verified by the quantitative analysis. Doing exactly what you say you're doing is less common than you might think! They go on to show that his Sharpe ratio is quite good (not a surprise) but not the "three Sharpe ratio" that seems to be the holy grail of many hedge funds. Such a

high Sharpe would lead, if real, to very few periods of pain, most of them lasting for about an hour and a half (e.g., "Honey, it was a horrible week at the office as we lost money for most of Thursday afternoon, but it's all ok now. Hold me."). Now, his Sharpe is quite good, but, as they show, it's less than 1.0. We think that a Sharpe between 0.5 and 1.0, that can be done at large size, is a tremendous thing. So, while it might surprise some who are used to hearing about the latest hedge fund that claims to offer a 2.0 or 3.0 Sharpe ratio, Buffett has managed to achieve his amazing feats with a very good but still "human" risk-adjusted return. Basically, you can say my colleagues' paper shows it's pretty easy to become one of the very richest people in the world. Just pick a few good factors.[5] But there's one more catch…

I've left something out. There's another thing I stress in this story that comes out of my colleagues' research, and it's likely the hardest part of what Buffett has done. One of the secrets of Buffett's success is that he takes a lot of volatility. In fact, he runs a portfolio with volatility generally well north of the S&P 500.[6] Furthermore, he produces this by leveraging a portfolio that stand-alone would be less risky than the S&P. There's nothing wrong with that (in fact we think it's kind of right). But the real magic skill of his is that despite some fairly horrific and none-too-short relative and absolute return periods, he's stuck with his style, and his risk level, like grim death.[7] There's no sign he's ever backed off through multiple down years and drawdowns, including a horrific experience during the technology bubble when he underperformed the stock market by 76%. At the risk of being too obvious – we think the lesson here is do something you believe in based on basic economics and as much evidence as humanly possible, that can be done at high capacity and generates reasonable risk-adjusted returns that improve your portfolio, and then stick to it[8] when it will inevitably test you more than you imagined. Again, in our opinion, that is the simple, but <u>really not easy</u>, recipe for investment success.

I will leave it to past and future blogs to discuss the long-term evidence,[9] the long period of successful real life returns, and the even longer backtests, for what we do, and why our belief in our strategies is unshaken (e.g., the strategies have clearly not been arbitraged away, they have not gotten too expensive to trade, etc.). Here I will just remind everyone, including myself, that this is all much harder to do in real life than many think before experiencing these times. We have been through it before, and we certainly knew all this sixteen months ago (see above!) when times were great. And, yet, it's still excruciating when it happens. That is, perhaps, the point and indeed why the strategies don't get arbitraged away (or, as I say in the old presentation excerpt, "grow to the moon"). This stuff is hard! Easy things do get arbitraged away. Hard things less so.

We didn't think we were so great sixteen months ago (though I think we were pretty good!) and I don't think we stink now (quite the opposite, but I'm known to be arrogant). In investing, perhaps more so than many other fields, you truly have to learn to "…meet with Triumph and Disaster And treat those two impostors just the same."

If all of us, as investors, can persevere, we believe the long-term benefits are great (sunlit uplands and all that). But, even knowing all this in advance doesn't make it easy. Hopefully, this reminder of what we all knew sixteen long months ago is helpful (to me too!).

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[1] Doomed to know the future but not be able to convince anyone about it or change it.

[2] I used it in various, though always very similar, forms. The one presented here is specifically an exact cut-and-paste from my presentation at Institutional Investor's Winter Forum in February of 2017 – about a year before this painful drawdown for us began.

[3] As of now. We will never give up trying to forecast them. Though, much like trying to time the market, I don't forecast tremendous success for such forecasting!

[4] I have discussed in these blogs, and with many of you in person, how I always (again IMHO) act rationally when it comes to how AQR follows our process. But, I am not always so rational in the short term when it comes to my own behavior. Besides some now well-known first degree monitor abuse, I'm also, occasionally, the client-from-hell internally. I'm not above raging about short-term performance, forgetting that streaks are much more common than many would assume (e.g., "how can this be down X months in a row?!?"), or searching for simple explanations in a world where, uncomfortably, randomness rules at all but the long term (when it still matters but less and less). I think feelings like mine are what leads to the behavioral biases we trade against – but it would be nice if the physician could heal himself! Of course, I can turn this personal negative into a process positive. If I have been doing this for 25 years (I have) and can't get rid of these irrational emotional biases, then perhaps they will be far more long-lasting in markets than many might guess.

[5] Of course, he picked them, implicitly, many years before some of the famous research "discovered" them. Also obviously, my very point here is that it ain't that easy!

[6] Yes, yes, volatility isn't a perfect measure of risk and all. It's literally peeve #1.

[7] Some point to his setting himself up using insurance float to finance his purchases as making this act of perseverance easy. First, if it was so easy why didn't everyone do it? Second, and more important, even if your source of financing is rock solid, many, even most, investors would still find it difficult to stick through such hard times as it's not all about solid financing it's also more about not losing faith in the process.

[8] Stick to it only after always reviewing whether you're missing something or whether recent performance is a consequence of something understandable and perhaps preventable (in which case you shouldn't stick to it like grim death… you should change!). We assume Mr. Buffett conducts much the same exercise all the time, as we do.

[9] In fact, my colleagues recently finished a paper that looks at a lot of the themes we focus on at AQR, namely style investing, going back nearly a century and find once again that there is broad and incredibly long-term empirical support for these ideas.

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