PORTFOLIO RISK AND PERFORMANCE

Which Risks Have Been Best Rewarded?

December 1, 2004

An empirical study examines the consistency of rewards for bearing various types of risks in U.S. asset markets between 1985 and early 2002.

Bearing duration risk and equity market risk was amply rewarded, while bearing long-dated credit risk and buying credit-risky (low-grade) bonds realized puny average profits. Bearing short-dated credit risk gave the most consistent profits of all static overweight strategies, with an information ratio near one.

Wide break-even spread cushions may be one explanation for what may be considered superior reward for risk at short maturities. More fundamentally, market segmentation seems to be the main explanation, because the most consistent profit opportunities involve switching from Treasuries to top-rated non-government bonds.

Hypothetical performance results have many inherent limitations, some of which, but not all, are described herein. Hypothetical performance results are presented for illustrative purposes only.

Diversification does not eliminate the risk of experiencing investment loss.

Certain publications may have been written prior to the author being an employee of AQR.

This material is intended for informational purposes only and should not be construed as legal or tax advice, nor is it intended to replace the advice of a qualified attorney or tax advisor.