



Market Risk And Efficiency

Inflation in 2010 and Beyond — Part II

July 1, 2010

AQR White Paper

Traditional institutional portfolios with risk characteristics similar to a 60/40 stocks/bonds allocation are not well-positioned for unexpected inflation. Our conclusion is based on the following findings:

- Stocks are not effective inflation hedges, particularly in the short- and medium-term
 - Traditional institutional allocations resemble a “bet” on moderate inflation
- However, while predicting future inflation is challenging, a risk-based approach to strategic asset allocation may generate more balanced performance across both inflationary and deflationary periods. We also find that:
- Tactical hedging against inflation or deflation can be accomplished more effectively with strategies that have a high beta to unexpected changes in inflation
 - Waiting for a period of high inflation (or inflation uncertainty) to occur may be too late to efficiently hedge against its negative effects
- Our analysis examines periods of increasing and decreasing inflation but focuses on unexpected changes which lead to revaluations of asset prices. One of the main drawbacks of traditional inflation analyses is the limited number of observations, as well as the absence of data for some assets such as TIPS in stagflation. A benefit of our focus on unexpected inflation is the ability to observe multiple data points of asset performance in both inflationary and deflationary periods (160 inflation surprise periods vs. only 22 inflation regime periods).

This document is not intended to, and does not relate specifically to any investment strategy or product that AQR offers. It is being provided merely to provide a framework to assist in the implementation of an investor's own analysis and an investor's own view on the topic discussed herein.

This document has been provided to you solely for information purposes and does not constitute an offer or solicitation of an offer or any advice or recommendation to purchase any securities or other financial instruments and may not be construed as such. The factual information set forth herein has been obtained or derived from sources believed by the author and AQR Capital Management, LLC (“AQR”) to be reliable but it is not necessarily all-inclusive and is not guaranteed as to its accuracy and is not to be regarded as a representation or warranty, express or implied, as to the information's accuracy or completeness, nor should the attached information serve as the basis of any investment decision. This document is not to be reproduced or redistributed to any other person. The information set forth herein has been provided to you as secondary information and should not be the primary source for any investment or allocation decision. Past performance is not a guarantee of future performance. Diversification does not eliminate the risk of experiencing investment losses.

This material is not research and should not be treated as research. This paper does not represent valuation judgments with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of AQR. The views expressed reflect the current views as of the date hereof and neither the author nor AQR undertakes to advise you of any changes in the views expressed herein.

The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided

herein are for illustrative purposes only. The information in this presentation has been developed internally and/or obtained from sources believed to be reliable; however, neither AQR nor the author guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.