ASSET ALLOCATION

Tactical Tilts and Foregone Diversification

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AQR Note to Investors

Tactical timing may be defined as dynamically changing allocations to two or more assets or strategies (or between a single asset and cash) in an attempt to increase returns. While rebalancing to constant weights already requires some turnover, tactical timing typically involves additional turnover and so any benefit must exceed the additional transaction costs incurred.

Investors tend to forget that tactical timing may incur a further penalty, which relates to forgone diversification. This penalty is larger for assets or strategies with low correlations to each other. So, for example, the penalty is more significant for tilts between stocks and bonds than for tilts between highly correlated equity sectors or countries.

At AQR, we are continuously researching potential indicators of time-varying returns of assets and investment strategies. But we also believe in diversification, and we therefore employ such tactical signals only where, and in such a way that we believe they can overcome the diversification hurdle described in this note.

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statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.