

## MEMORANDUM

TO: Proposed Rule: Use of Derivatives by Registered Investment Companies and Business Development Companies  
(Release No. IC-31933; File No. S7-24-15)

FROM: Sirimal R. Mukerjee  
Senior Counsel, Division of Investment Management

RE: Meeting with Representatives of AQR Capital Management, LLC (“AQR”)

DATE: March 22, 2016

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On March 22, 2016, Diane C. Blizzard (Associate Director, U.S. Securities and Exchange Commission (“SEC”), Division of Investment Management (“IM”)), W. Danforth Townley (Attorney Fellow, IM), Michael Spratt (Assistant Director, IM), Brian McLaughlin Johnson (Senior Special Counsel, IM), Thoreau A. Bartmann (Branch Chief, IM), Adam Bolter (Senior Counsel, IM), Samantha Brutlag (Senior Counsel, IM), Sirimal R. Mukerjee (Senior Counsel, IM), Jamie Walter (Senior Counsel, IM), Christof Stahel (Assistant Director, Division of Economic and Risk Analysis (“DERA”)), Jae Hyun Choe (Economist, DERA) and John Cook (Senior Special Counsel, DERA) met with the following representatives of AQR:

- David Kabiller, Co-Founder and Principal
- Michael Mendelson, Principal and Portfolio Manager
- Marco Hanig, Principal and President of AQR Mutual Funds
- Mina Nguyen, Senior Advisor and Head of Corporate Policy
- Brendan Kalb, General Counsel
- Nicole Donvito, Senior Counsel and Head of Registered Products

Among other things, the participants discussed the SEC’s proposal relating to the use of derivatives by registered investment companies and business development companies, including the information provided by AQR set forth in Annex A.

*[Attachment]*



# Proposed Rule 18f-4

## Discussion Document

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# Outline

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Who Is AQR?

Derivatives Use in Mutual Funds

AQR's Thoughts on Proposed Rule 18f-4

Questions



# Who Is AQR?

At the Intersection of Financial Theory and Practical Application

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**Founded in 1998, we manage approximately \$150 billion in assets\***

**Privately held with 26 principals and over 600 employees**

**Our clients include both institutional investors (e.g. pension funds, endowments, sovereign wealth funds) and financial advisors and their individual clients**

**AQR is among the largest managers of “liquid alternative” strategies, managing approximately \$30 billion across AQR Funds and sub-advised funds\***



\*Approximate as of 3/17/2016, includes assets managed by CNH Partners, an affiliate of AQR.

Sources: AQR, Morningstar.

# Derivatives Use in Mutual Funds

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**We believe that derivatives used in mutual funds are largely simple, liquid, and easily valued**

- Exchange traded futures
- Currency forwards
- Total return swaps on simple underlying assets (like equities and equity indices)
- Interest rate swaps

**Data on their use is difficult to gather from public filings because of reporting insufficiencies**

**A comprehensive survey just completed and covering more than 80% of industry AUM shows that many hundreds of funds and over \$600 billion of assets would be affected by the proposed exposure limits**

- While the percentage of funds affected is modest, they represent a substantial portion of the diversifying choices for average investors
- Common theme across affected funds is extensive use of derivatives on low risk underliers



Source: AQR, ICI. The Investment Company Institute (ICI) recently conducted a survey of funds that provides useful insight into the likely impact of the proposed rule on various categories of funds. An ICI draft analysis as of March 11, 2016 reports that the survey received responses from 6,661 funds with assets totaling \$13.6 trillion. The numbers reported in the ICI's draft analysis are subject to change.

# Derivatives in Mutual Funds Have Essential Uses

## Simple Derivatives Are the Mainstay of Use in Funds

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### **In mutual funds, valuable uses of derivatives include**

- Delivering strategies that help investors diversify away from over-concentration in stocks, which are high risk and correlated to investor incomes, job security, and home values
- Managing redemption risk
- Reducing liquidity risk in funds
- Enabling exposure to diversifying assets like commodities
- Hedging portfolio risks
- Enabling low risk assets like government bonds to be meaningful in investor portfolios
- Reducing trading costs and reducing cash drag

### **But typically don't, and probably shouldn't, include uses of derivatives that**

- Amplify leverage to risky assets
- Concentrate risks in places investors are likely already too concentrated
- Hide risks via complexity
- Combine leverage and illiquidity
- Are used in conjunction with poor collateral management practices

### **Rules should encourage the former and discourage the latter**



Source: AQR.

# Some Thoughts On Proposed Rule 18f-4

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**Agree with objectives of investor protection, sound risk management, and improved governance**

**Sound risk management requires limitations on portfolios**

- As simple as sensible, but no simpler

**Technical Observations of the Proposed Rule**

- Gross notional exposure does not capture riskiness of underlying derivatives
- Discourages the use of derivatives on low risk assets, but not much on derivatives on high risk assets
- Asset coverage test is unnecessarily restrictive

**The Proposed Rule could take away investors ability to diversify risk away from their over-concentration in equities into lower risk assets or strategies**

- By relying on the simplest notional exposure test, it discourages risk-controlled applications, threatening to force the abandonment or drastic restructuring of important diversifying strategies



Source: AQR.

# Suggested Modifications

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## **Definition of “exposure” for portfolio limits**

- Replace “aggregate notional amounts” with “risk-adjusted exposure” based on a published table of risk-adjustment factors

## **VaR test to qualify for higher risk-based portfolio limit**

- Adopt an absolute VaR test

## **Definition of “qualifying coverage assets” for derivatives coverage**

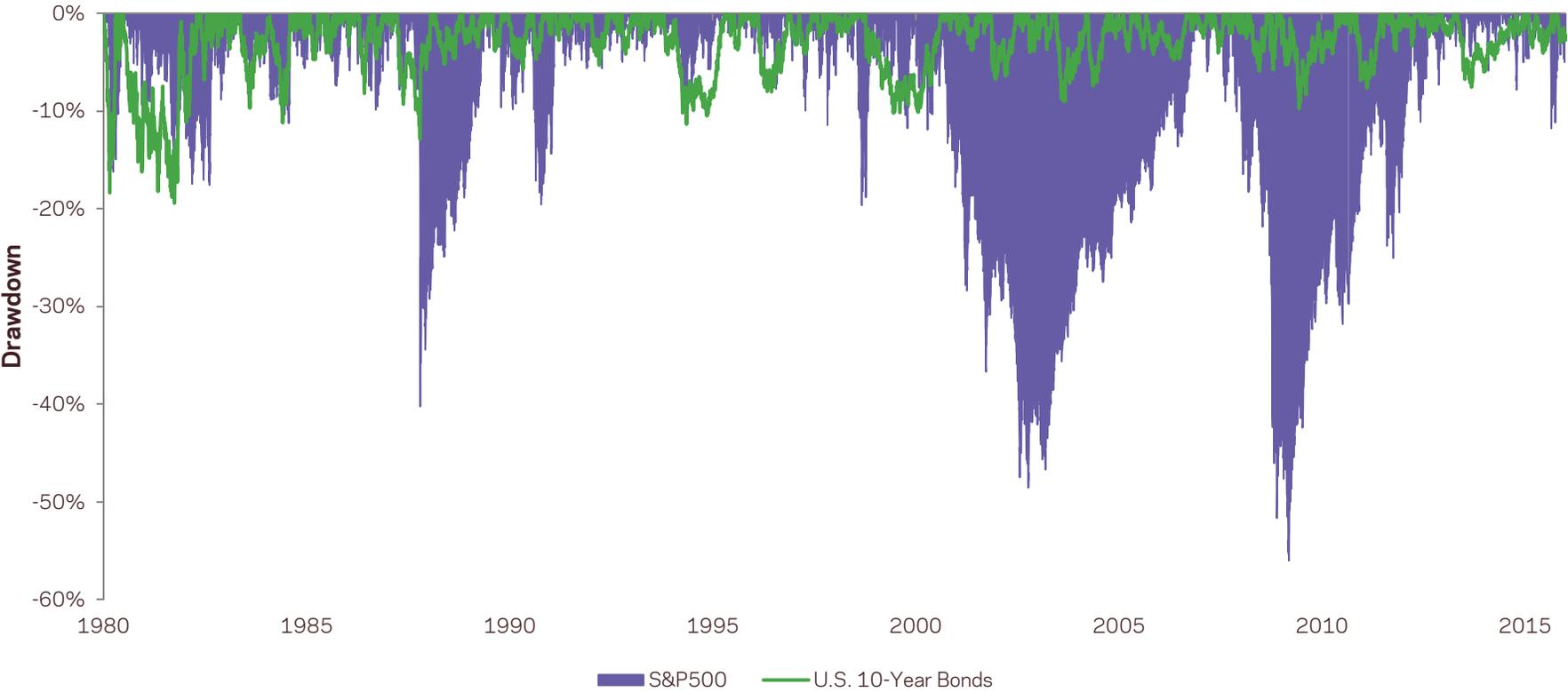
- Include highly liquid assets adjusted by a haircut schedule



Source: AQR.

# Stocks Are Riskier Than Treasuries by Any Common Measure

## Drawdowns Experienced by Holders of the S&P500 and 10-year UST



Source: AQR, Bloomberg. For illustrative purposes only and not based on an actual portfolio AQR manages. Past performance is not a guarantee of future performance.



# AQR Managed Futures Strategy Fund

## Low Volatility Assets Contribute Much Notional Exposure but Less Risk

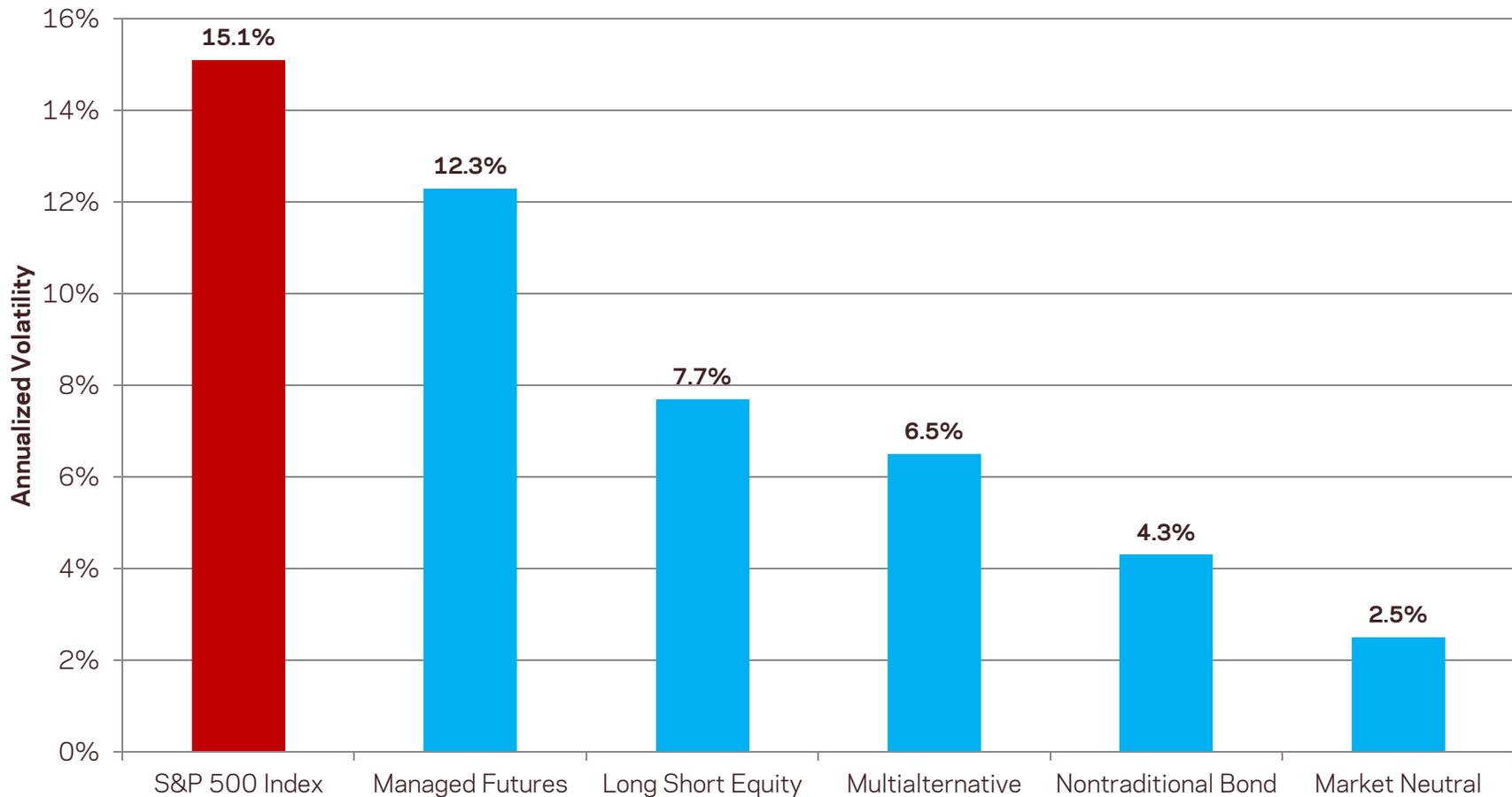


Source: AQR. As of December 31, 2015. Ex-ante portfolio volatility is an estimate, and does not guarantee future results. Ex-ante volatility is calculated by using positions as of December 31, 2015 and historical volatilities and correlations of the individual securities within each asset class. Notional exposure for short-term interest rate futures was calculated based on Number of Contracts \* Contract Unit (e.g. \$1,000,000). Exposures are subject to change at any time without notice. Past performance is not a guarantee of future performance.



# Risk Characteristics of Alternative Mutual Funds

Typical Risk Levels Are Less or Much Less Than the Risk of Stocks



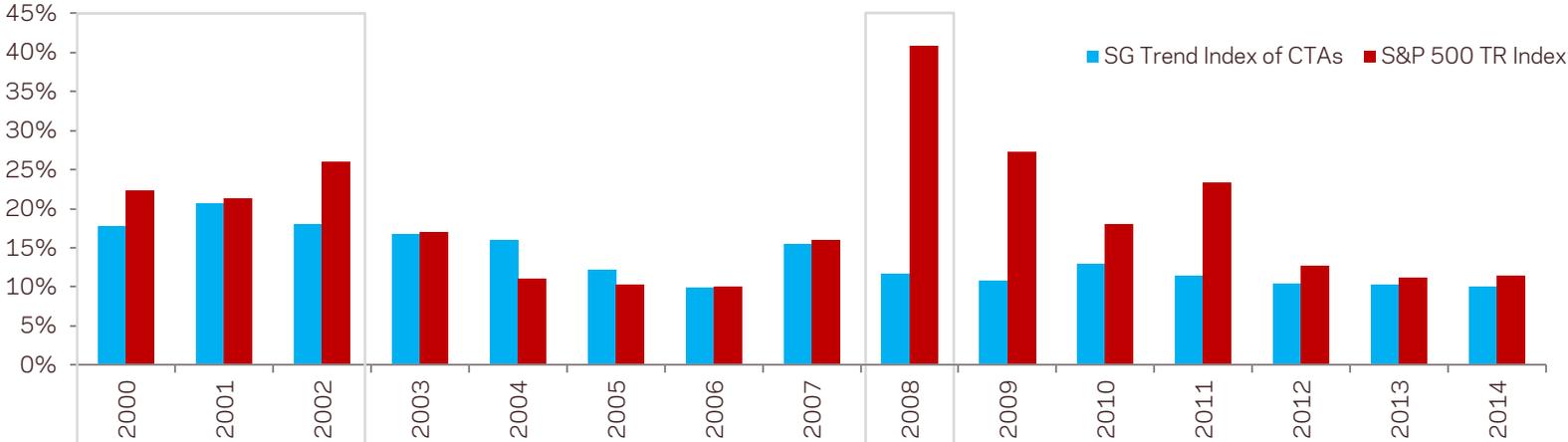
Source: Morningstar. Based on monthly Morningstar Liquid Alternatives Category averages from 2006 to 2015. 2006 is the first year that data is available for all five categories. For illustrative purposes only and not based on an actual portfolio AQR manages. Past performance is not a guarantee of future performance.



# Alternatives Offer Diversification for Investors

## Example: Managed Futures Strategies

### Annualized Realized Volatility



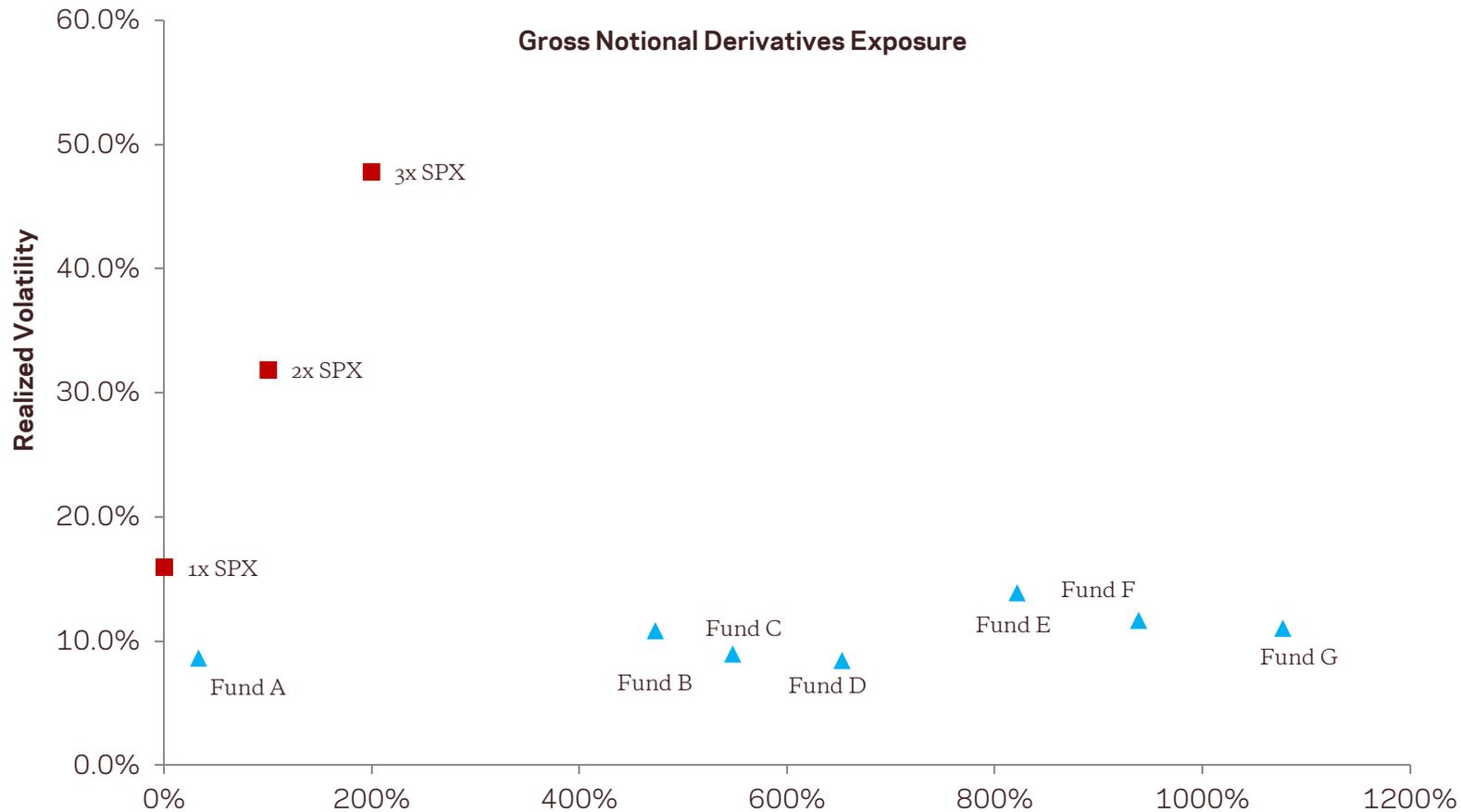
### Annualized Returns



Source: AQR, Bloomberg. Annualized returns and volatility from January 2000 to December 2014 using daily data. The SG Trend Index is designed to track the largest 10 (by AUM) CTAs and be representative of the managed futures trend-following space. Data is not limited to managers of managed futures registered funds. For illustrative purposes only and not based on an actual portfolio AQR manages. Past performance is not a guarantee of future performance.

# High Notional Exposure Does Not Equal High Risk

## But High Notional on High Risk Assets, Does



Source: AQR, SEC <http://www.sec.gov/edgar/searchedgar/mutualsearch.html>. As of September 30, 2015. The time period is different for each fund based on the inception date of each fund (ranging from 2005 - 2014), and since earliest fund inception for SPX Index. Analysis conducted by AQR for 7 of the top 10 Managed Futures Funds by AUM for which meaningful exposure data could be obtained and that report underlying positions to SEC. Notional exposure for short-term interest rate futures was calculated based on Number of Contracts \* Point Value \* Price (e.g. \$250,000). Exposure subject to change at any time without notice. For illustrative purposes only and not based on an actual portfolio AQR manages. Past performance is not a guarantee of future performance.

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