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Frank J. Fabozzi: Describe the process of developing your firm's investment strategy and how you adapt it to changing market conditions.

Clifford S. Asness: Our investment strategy came out of academia, which means it's grounded in economic theory and backed by statistical evidence. These two taken together have always been important to us because any quant can come up with a good backtest—that's actually the easy part! Far fewer can come up with something that looks good and is also supported by sound theory to explain why it should work going forward. This academic-type discipline is obviously helpful to avoid data mining, but it's also helpful when a good strategy has a bad stretch—it helps avoid the "this time is different" thinking that leads so many investors to change their process at exactly the wrong time. Sometimes this time is indeed different, and you can't be dismissive of that chance, but it usually isn't.

None of that means our investment strategy is static. We're always balancing sticking with our core beliefs with bringing new ideas into the process. Our models evolve with new research, our implementation gets better. The AQR of 1998 is positively correlated, but actually less than you might guess, with the AQR of 2024.

Importantly, adding new stuff doesn't mean one-for-one getting rid of the "tried and true." This is for two reasons. The first is just math. A new signal, if it's really new, will be at least somewhat diversifying to the rest of the portfolio, meaning you can add more of it than what you take out of the existing signals and still be within your risk targets. The other reason is more conceptual: the new stuff can be, and often is, refinements of things we already do—whether it's using language models to find a new way to measure a theme, such as "fundamental momentum," that we already like, or whether it's adding new assets to the opportunity set, or using machine learning to better combine existing signals. We try to be good Bayesians about all this, making sure that the way we evolve our process reflects the right combination of our priors and live results.

Fabozzi: What key performance indicators do you prioritize when assessing the firm's investment success, and why?

Asness: Total returns are the easiest thing to look at, they're what most of the world focuses on, but they are also usually the wrong metric to assess if we or any manager is doing a good job. Take hedge funds. I've been arguing against evaluating hedge funds by their raw performance for more than two decades, including my two-part series in this journal in 2004 ("An Alternative Future" Part I and Part II) and my coauthored article "Do Hedge Funds Hedge?" alongside my colleagues Bob Krail and John Liew, which appeared in the Fall 2001 issue.

And it's not just hedge funds, by the way. The privates industry by and large is making the true, honest measurement of investment skill and client value-add even murkier.

The performance indicators I look at are the same ones I think our investors should look at, and I like to think a fair part of my career has been about raising investor awareness about this. The easiest thing is separating alpha from beta. Don't give something alpha credit for beta returns. Just because a 2-and-20 hedge fund delivers high returns over multiple years doesn't make cause for celebration. If those high returns are perfectly correlated with equity markets, investors are probably much better off indexing.

Related to this is how additive a strategy is to the rest of an investor's portfolio. Our goal is to deliver results that improve the risk-adjusted returns of our clients' overall portfolios, and our ability to do so is the overarching metric we should all be focused on. But it's not easy, it's not how the industry reports performance, and it's often not how outside investors evaluate whether a strategy is working. In theory, we should all calculate "alpha to the rest of our portfolio." But in practice, it's hard—it means looking past line items in a portfolio review and focusing on contributions to the whole.

One addendum: This seems obvious, but one must always focus on the right long-term goal. The most glaring example here is investing for a taxable versus a tax-exempt investor. So often, even for taxable investors, only the top line (pretax returns) is focused on in evaluating a strategy or manager. One of the capabilities we've developed in the last 10 years is to get super-efficient in managing for taxable investors.

Fabozzi: How do you approach risk management? Can you provide an example of a time when your approach significantly impacted your firm's performance?

Asness: Risk management comes in many forms, but I'll focus on market risk. At AQR, it starts before our dedicated risk management team even gets involved. Our security selection process, in which portfolio views are initially formed, already hedges out unwanted and uncompensated risks. For example, it should surprise absolutely no one that value is a theme (among many) that AQR trades on. But for most managers, a value tilt ends up being not only about the cheapness of a specific stock but also about the industry that stock happens to be in. Said another way, for a lot of managers, having a value bias often means having two bets: one on cheap companies and one on cheap industries. We try to hedge out the industry bias for a few reasons. The first is intuitive: comparing the valuation of a tech stock with the valuation of a utility is pretty apples-to-oranges and thus often not very informative. The second is in looking at the data: The industry risk component of a value strategy empirically tends to be poorly compensated.

Our "intra-industry" approach usually helps a bit, but sometimes it can matter a ton. Take 2023 as an example, a huge year for stocks generally, and especially technology stocks. Most forms of value investing—you can look at the Russell Value indexes as an example—underperformed, often dramatically, simply because they were underweight or short industries like tech and overweight or long industries like utilities. But the value theme *within* industries actually did quite well, leading to a good year for our version of value (full disclosure—while by definition we prefer our approach, there are certainly many times the traditional approach outperforms!).

If our portfolio managers/model designers are our first line of defense against unwanted risks, our risk management team is our second. Things like leverage caps, position limits, portfolio-wide risk reduction are all things risk management can and does impose separately and independently from portfolio managers. That said, while it's good to have risk management be independent of portfolio management, that doesn't mean they should be siloed. On one hand, you need to empower your risk managers to make calls. But you also want them to be part of the culture, to understand the process, and to have immediate access to portfolio managers.

Going back to the top, market risk is only one prong of risk management. We take an enterprise-wide view: counterparty risk, operational, regulatory, cyber.... Sorry, Frank, how many words was this answer supposed to be?

Fabozzi: In what ways has the integration of technology changed your asset management strategies over the past decade?

Asness: Technology has always been a big deal for us because it underlies our ability to get better at what we do. In some sense, we consider our firm a marriage of (applied) academic finance and technology. Testing strategies, new research, risk management, trading, creation of new data sets—these are all tied to our investment in technology.

Of course the splashiest technological innovations of the past few years are natural language processing (NLP) and machine learning (ML). Don't get me wrong; they're both cool. But they're also not new. Quants have been processing unstructured data for a long time. Central bank transcripts, earnings calls, these are sources of information that don't come in nicely formatted spreadsheets but that are sometimes pretty easy to convert into a useful format.

Pre-ChatGPT days, quants would simply write a program to count how often a "good" word appeared in an earnings call transcript; like, for example, the word "increasing." The more times that word appeared, the more attractive the company. Obviously, this wouldn't work all the time. You can imagine the statement "massive embezzlement-driven losses are increasing" would be a problem for this simple approach! Of course, as quants that's OK to happen, as it's not more than roughly half the time! But today, we think we can do better. One of the benefits of today's versions of NLP analysis of these same statements is that they're better at context, and this allows us to refine old signals, create a bevy of new ones, and test new models. But again, we see this as an evolution, not a revolution, to how we've always approached unstructured data.

Despite all the cool applications for ML, there are some important things I don't expect it to be able to answer any time soon. Long-term economically important questions like, What's the equity risk premium? Or what's the premium for investing in quality stocks over junk stocks? These are important questions, but financial markets don't provide enough data for any machine to answer those kinds of questions. Essentially, they are not big data problems; they are small data problems. In many cases, theory and economic common sense are still a researcher's best friends.

Fabozzi: How do you balance client expectations with the realities of market dynamics and investment performance?

Asness: It can be hard!

A big part of what we aim to do is deliver truly diversifying returns. In theory, that's super valuable to investors. In practice, it's a super tough business model.

If you have a strategy that's truly uncorrelated with stock and bond markets, it can be hard to explain times when you outperform or underperform. The market going up or down is always an easy story for those relying on beta, but it gets harder when it's a diversifier you're trying to explain. And if that same strategy is diversified across thousands of positions intra-industry, how do you explain a good month or a bad month (or year or more!)? And if that uncorrelated, thousand-position portfolio also has hundreds of investment signals—many of which themselves are uncorrelated with each other—how do you give any sort of intuition or set expectations for the client?

Our answer is to share and overshare. We publish more than (probably) any other firm, and we make our datasets and journal articles freely available to investors and the broader community. And it's not only because we think educating the world about systematic investing makes the world a better place (for the record, we do think that).

Going further, during the underwriting process, we go out of our way to discuss when a strategy might temporarily underperform (with “temporary” being up to a few years in the real world!). For example, if markets aren’t respecting fundamentals, our stock selection strategy might temporarily underperform as it becomes more attractive on a go-forward basis. If macro volatility is below normal, our trend-following strategies might underperform expectations as there’s just not that much interesting for them to capitalize on. If there is a liquidity shock, our arbitrage strategies might temporarily experience stress as they, again, become more attractive on a go-forward basis.

You won’t be shocked to know an element of greed underlies our desire to share our research and insights. We believe investors who know what we do, how we do it, and why—as well as having access to the research that underlies our processes—make better long-term clients. They are more likely to stick with us through the ups and downs and ultimately realize the long-term alpha we expect from our strategies (sometimes, that even works).

Fabozzi: How has the growing emphasis on environmental, social, and governance (ESG) factors influenced your investment strategies?

Asness: We’ve always been honest with investors about this. Too many managers have sold ESG as a way to do good and at the same time improve investment performance.

Any time a constraint is added to a strategy, regardless of what kind of constraint it is, it should be expected to detract from that strategy’s expected ex ante “alpha” (ex post of course is a different matter). Screening out certain securities from the opportunity set is a constraint, and one that lowers expected risk-adjusted returns.

But for ESG investors, that’s not a bad thing! The mechanism by which ESG investors can influence markets is by altering companies’ cost of capital. Take “brown stocks” as an example. By shunning these high-carbon-footprint stocks, ESG investors seek to lower their share prices, which pushes up their cost of capital, with the goal of making future projects for those companies more expensive to undertake. So yes, there is a small expected cost to being an ESG investor (at least one who does that by excluding the “bad guys”), but it’s that small expected cost that’s precisely how such an investor hopes to influence the world to the better. So many overpromise in ESG, ignoring this trade-off, and in fact never explaining how not owning something can actually help the world to begin with. We think we approach this honestly and actually explain how it can work.

What bugs me is why the discussion so often stops at divestment. Why does the idea of “let’s penalize these companies” stop at zero weight in a portfolio? Shorting is a way for ESG investors to do even more. If investors are short a bad stock, it means other investors have to demand even more to own it, which they will only do at still lower prices, pushing the cost of capital for these firms even higher.

Not only that, allowing shorts into an ESG portfolio may also help the investor. Take the case of minimizing a portfolio’s exposure to carbon. If the portfolio excludes carbon-producing companies, the investor can end up with a fairly concentrated portfolio and one that should be expected to have lower risk-adjusted returns than the index. But by shorting a subset of the worst climate offenders, a long–short portfolio can actually get its exposure to zero and maintain better portfolio diversification. That’s been a big part of AQR’s approach for ESG investors. By pursuing their objectives in a long–short framework, we think we’ve been able to address their objectives more efficiently than conventional approaches.

Fabozzi: Can you describe your leadership style and how it influences your investment team and firm culture?

Asness: Sure. I'm very soft-spoken and reserved, probably to a fault. And I take investment losses very stoically.

Ok, my leadership style is not that. It's direct, open, and I hope usually constructive! A lot of this comes straight from academia. We try to run AQR as a place where the best idea wins, no matter who says it. Our investment process is team-based, and even across teams we encourage collaboration and dialogue. If a researcher has a great idea in one asset class, we want to know about it so we can test it in others.

We run a vibrant seminar series, have joint research meetings across groups, have people involved in multiple efforts across groups. Dialogue, debate, skepticism are all encouraged. We try to avoid bureaucracy, which means the organization is a lot flatter than a lot of people might assume. And, while we do acknowledge and sometimes bow to the trade-off, we usually err on the side of openness, both externally and internally, rather than "proprietary trade secrets." We think long term we build a better investment process and team this way.

Fabozzi: How do global economic trends influence your investment decisions, and how do you prepare for potential international crises?

Asness: I'll split your question into two parts. Trends can be picked up in portfolios in two basic ways: the first is from prices, the second is from fundamentals—the latter we call "economic trend." Price trend is something that we've been capturing explicitly for nearly 15 years in our macro strategies. The gist of how we implement economic trends is to go long assets in which macroeconomic trends are improving and short assets for which macroeconomic trends are deteriorating. Price trends and economic trends are correlated, but still complementary, as sometimes markets can seem disconnected from fundamentals, and sometimes they seem driven by fundamentals. Having both in our process we think does a better job at picking up the broader concept of "trends."

The second part of your question, potential international crises.... Well, we don't think anybody has a crystal ball. We certainly don't. Generally the best defense is not to be too ex ante exposed to one or a handful of bets, which means be broadly diversified. For equity investors, this means being global. Now, to be clear, global diversification won't save you from short, sharp crashes, but that's actually not the risk long-term investors should be most worried about. The really bad outcome for long-term investors is a protracted bear market, and here we find global diversification can be quite helpful, particularly if your country is the epicenter of the problem (and nobody should ever rule that out).

Investors can do more than just diversify their equity exposure: They can diversify away from equity risk more generally. This is where alternative assets can play a role, but with a very important caveat—make sure the alternatives allocation is actually diversifying! Some "alternatives" (hint: private equity and private credit) are mostly repackaged super-expensive exposures to equity and credit premia and as such are unlikely to be helpful when investors need diversification the most, unless you count not having to report the true returns as diversification (which we do not so count).

Finally, among truly diversifying alternatives, one strategy that historically has actually had its strongest performance when stock and bond markets (and their private equivalents) have done poorly is, again, trend following. We've written about trend-following strategies as having a "dual mandate": positive returns on average and higher-than-average returns in very bad times for most investors. Our research and experience suggest trend is one of the few things that can meet these twin objectives (nothing is perfect, but on average). AQR has devoted a ton of new research into these strategies over the past 10 years, adding new signals, new asset classes, and even factors, into the mix, all preserving the spirit of trend following (we're not sneaking in beta or carry strategies) and preserving the positive convexity of trend following (the tendency to do well in extreme sustained bear markets).

Fabozzi: What experiences have most shaped your approach to investment management, and what advice would you give to someone aspiring to become a CIO?

Asness: I have two very different answers here. The advice I give to anybody aspiring to become a CIO is "get lucky early." Yes, it's glib—but it's true: good luck is almost certainly the best thing that can happen early in someone's career (it doesn't hurt late in one's career either). More seriously, acknowledging the role of luck in any successful path is just honest.

On the other hand, what's been most important for me has been the bad times. AQR started right before the blow-off last 18 months of the late 1990s tech bubble (or dot-com bubble), which, as students of ancient history may recall, was pretty much the worst-ever time to have long–short exposure to the value premium, with factors like "quality" not really helping as nobody wanted that either. But the bad times are when you have to look most critically at your process (if you truly think your process is now broken forever, not just having a very hard time, change it!), re-underwrite your beliefs and your process, and hopefully have learned something when you come out the other side.

I hoped the insanity of the tech bubble would be a "once-in-a-career" aberration. It wasn't. 2018–2020 was very similar, but in many ways worse—with dislocations in valuations not only wider but also more widespread and lasting longer. Have these episodes contributed to my hair loss? Yes. Have they shaped my thinking about the right way to invest and, I think, actually made us better investors? Also yes.