



# AQR Diversified Arbitrage Fund

## Fourth Quarter 2013 Commentary

January 2014

### Performance Summary

	Total Returns as of Quarter-End 12/31/13					
	4Q 2013	YTD	1 YR	Annualized		Since Inception (1/15/2009)
ADANX	-0.13%	1.42%	1.42%	1.67%	5YR	3.65%
ADAIX	-0.06%	1.75%	1.75%	1.95%		3.96%
ML 3-Month T-Bill Index	0.02%	0.07%	0.07%	0.10%		0.13%
ADANX Gross/Net Expense Ratio/Expense Cap: 2.69%/2.69%/1.50%				ADAIX Gross/Net Expense Ratio/Expense Cap: 2.39%/2.37%/1.20%		

*Performance data shown represents past performance and is not a guarantee of future results. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. Call 1-866-290-2688 or visit [www.aqrfunds.com](http://www.aqrfunds.com) for current month-end performance.*

### Fund Overview

The Fund seeks to capture liquidity premia by investing in various arbitrage strategies, many of which are related to major corporate events. As in our prior quarterly letters, we compare the Fund's performance to the S&P 500 and to U.S. Treasury bills. Our comparison to the S&P 500 is not because we consider it to be a relevant benchmark but rather to illustrate the Fund's low beta, as the Fund seeks to minimize systematic risk from equity markets. If the Fund holds a position which has stock market risk, we short a linked security, e.g., the acquirer's stock in a stock merger, or alternatively employ an indirect hedge, for example, shorting S&P 500 futures where a direct hedge is not feasible. For those positions that do not contribute systematic risk to the Fund's portfolio, we do not employ a hedging instrument. Although position-level hedges remove much of the risk from individual positions, there is often a residual amount of systematic risk that remains. This systematic risk is aggregated across the portfolio and hedged using interest rate futures, and credit and equity market indices. Since inception in January 2009, the Fund has a realized beta of 0.06 to the S&P 500 based on monthly returns. This near-zero beta is a direct result of hedging policies described above.

Although appropriate levels of portfolio hedges are estimated with error, the Fund's sensitivities to systematic risk factors have been small since inception suggesting that sizes of portfolio hedges have been roughly correct. Over the past year, portfolio-level hedge positions have been the largest negative contributors to the Fund's performance—an expected result in the face of strong equity and credit markets.



For example, the portfolio credit hedge reduced the Fund's profit and loss by 1.0% and the portfolio equity hedge by 1.9%. Of course, positive trends in equity and high-yield markets had an offsetting positive effect on the Fund's long positions. For example, holding stock prices constant, tightening credit spreads cause increases in convertible valuations. If equity and credit markets reverse course, we expect recent contributions to also reverse with losses to underlying investments and offsetting gains from portfolio hedges. Should this reversal occur, the Fund may benefit by capturing liquidity premia associated with arbitrage strategies.

We compare the Fund's performance to U.S. Treasury bills, which we believe is a better benchmark than the S&P 500 on a quarter-to-quarter basis. Like Treasury bills, the Fund has low systematic risk. Unlike Treasury bills, the Fund bears considerable idiosyncratic risk—mergers can fail, dual-class spreads and closed-end-fund discounts can widen, and corporations can default on their debt, all of which can negatively impact the Fund's returns even with well-constructed hedges. This idiosyncratic risk is managed at low cost through diversification. At the end of the third quarter, the Fund held 265 positions where the long-market-value was at least 0.10% of the Fund's net asset value. As a result, the Fund has realized low volatility (2.3% since inception) compared to that of the S&P 500 (15.2% over the same period). The Fund has a realized Sharpe ratio of 1.7 since inception, reflecting the low volatility of the Fund relative to returns in excess of those obtained from U.S. Treasury bills. Notwithstanding the low volatility and systematic risk of the Fund, it is not immune to extreme stressful periods such as the financial crisis of 2008 when corporate arbitrage strategies realized losses amidst the contemporaneous flight to quality. However, while losses are realized during periods of market stress and flight to quality, those periods also tend to be the most promising in terms of future returns for corporate arbitrage strategies.

## Performance Commentary

The 4<sup>th</sup> quarter return roughly zero at -0.06%, put simply, it was an extremely quiet quarter for corporate arbitrage. For example, the largest loss at the individual holding level was only 20 basis points, the result of a merger failure which generally triggers a much steeper loss. In convertible arbitrage, overall cheapening remained fairly constant over the quarter and there were no excess volatility events. Similarly, there was little activity in other corporate arbitrage strategies. For the full year, the gain of 1.75% was spread across strategies: merger arbitrage contributed 0.77%, convertible arbitrage contributed 0.43%, event-driven credit contributed 0.20% and remaining strategies contributed 0.35%. The contribution from merger arbitrage stemmed from successful deal closings in a stable and tight-spread environment. Deals generally closed on time and without major disruptions. The contribution from convertible arbitrage largely stemmed from modest richening of the convertible securities in the portfolio. The convertible richening appears to be driven by inflows into non-arbitrage convertible funds and has resulted in the pricing of some bonds above fundamental value. When this occurs, we sell the richly-priced convertible and reallocate the capital to cheaply-priced convertibles. In the current market, cheaper convertible bonds tend to be equity-sensitive as these behave like equities and are less attractive than balanced convertible bonds to non-arbitrage investors. For arbitrage investors, cheap in-the-money convertibles are attractive as the equity risk can be easily hedged via short sales of the underlying equity. The gain from the event-driven credit strategy was driven by several small investments in distressed securities, many involving companies in Chapter 11 bankruptcy. We tend to put small weights in distressed investments and hedge the portfolio of distressed securities using credit-defaults swaps on high-yield indices.

## Portfolio Positioning

Convertible arbitrage represents 53% of the portfolio's long value compared with 15% for merger arbitrage and 32% for corporate events and other arbitrage strategies. Within the latter strategy, event-driven credit accounts for 12%, spin-offs 7%, Special Purpose Acquisition Company (SPACs) 6%, closed-end-fund discounts 4%, and the remaining sub-strategies at 3%. While the convertible arbitrage strategy accounts for half of the portfolio's long market value, its effective risk weighting is much lower (roughly 30%) as the convertible portfolio consists of equity-sensitive (and thus high-delta) bonds. We believe that the Fund is sufficiently diversified across the three primary strategies, albeit with a smaller weight than normal in merger arbitrage. In addition to overall slow deal flow, the low weight in merger arbitrage reflects several successful



deal consummations prior to the year-end. At the end of the fourth quarter, the Fund's largest holding, Western Refining, had a 3.0% weight relative to the Fund's NAV. This holding is in the convertible arbitrage strategy with the long position in Western Refining's 5.75% convertible debenture hedged with a corresponding short position in Western Refining's common stock. The common stock of Western Refining closed on December 31 at \$42.41, far in excess of the debenture's \$9.77 conversion price. Because the convertible debenture is deep in-the-money, the hedged position has minimal fundamental risk as the Fund is indirectly long the underlying stock via the convertible debenture and short a similar amount of the underlying stock. Even in the improbable case of an immediate jump-to-default with zero recovery to the convertible debenture, the Fund would realize a loss of only 1 basis point, far less than the loss of 3.0% if the Western Refining convertible debenture were held as an outright (not hedged) position.

## Looking Forward

Opportunities in the corporate arbitrage space during 2013 were limited by low risk-free rates and a lack of robust deal flow. Low rates caused tight spreads across asset classes as investors sought yields in investments without equity market risk. In the corporate arbitrage markets, demand-induced spread tightening was not offset by new supply. This was especially true in merger arbitrage. Whereas the long-run average size of the merger market exceeds \$300 billion, in 2013 the merger market struggled to maintain levels greater than \$200 billion. Similarly, in the convertible market, redemptions exceeded new-issuance causing the convertible market to contract by roughly \$8 billion over the first three quarters of 2013. The decrease in the size of the convertible market was linked to the massive new issuance in the high-yield market. From September 2012 through September 2013, the high-yield market grew by an average of \$13 billion per month. Rather than issuing convertible bonds that contain dilutive equity options, corporate issuers instead opted to meet the demands of yield-hungry investors and issue straight corporate debt. In the event-driven space, short-dated credit opportunities (e.g. corporate bond tender offers) were scarce and as a result, capital was allocated to other opportunities including spin-offs, one of the few areas where deal flow is above average.

Although the merger market remains relatively quiet, there were signs of a turnaround in deal flow in the fourth quarter of 2013, particularly in the convertible market. During the fourth quarter, nearly \$20 billion of new convertible bonds were issued with multiple new issues coming to market on a weekly basis, reminiscent of pre-crisis activity. The sudden increase in convertible issuance is being driven by a combination of high equity prices and investors' aversion to bearing additional interest rate risk. Because the conversion price on a convertible bond is keyed off the pre-issue stock price, issuers are more willing to issue convertible bonds when their stock prices are high. In addition, investors' aversion to securities with interest rate exposure has caused a reduction in the appetite for fixed income securities, especially longer-dated debt instruments. As a result, issuers that are sensitive to the level of cash coupons are opting to issue convertible bonds where the equity upside associated with the conversion option induces investors to accept lower coupon rates.

The increase in convertible activity is welcome and will likely continue. Over the longer run, this is good for arbitrage strategies as increased supply will likely result in more attractive pricing. Still, we are maintaining conservative positioning in anticipation of a larger opportunity. Historically, arbitrage opportunities pay a small premium above the risk-free rate, compensation in our view for investors that provide liquidity around corporate events. More profitable opportunities in the arbitrage space typically coincide with macroeconomic developments. For example, improved U.S. economic conditions will generally be beneficial to merger deal flow as acquirers' confidence in financial projections increase and private equity buyers and lenders become more comfortable with leverage employed in leveraged buyouts. On the negative side, increased market volatility often causes arbitrage spreads to widen resulting in attractive investment opportunities, particularly in strategies like convertible arbitrage and dual-class arbitrage where the spread between prices of securities of the same issuer widens. Although it is difficult to know whether a U.S. government budget stalemate, Chinese credit markets, or some other macro event will be the catalyst, a common consequence is the redeployment of capital from one asset class to another, causing securities to trade at attractive prices. Given the current composition of investors in the convertible market where unhedged investors comprise a sizeable portion of the market, such a negative macroeconomic development could cause investor withdrawals and cause convertible securities to trade at theoretical discounts to their



fundamental values. While we don't know what the catalyst will be or when it will occur, we are confident that market-wide volatility cannot remain at the historically low 2013 levels over the long-run.

As of the end of 2013, the Fund's leverage was a modest 1.2X, and given the equity-sensitive, and therefore very well-hedged, nature of the Fund's convertible portfolio, this headline number overstates the economic leverage in the Fund. As a result, the Fund has plenty of buying capacity to take advantage of opportunities that arise. In the meantime, we will continue to run the portfolio with modest leverage and adequate hedges to maintain market, interest rate, and credit neutrality.



## Definitions

**Beta:** A measure of systematic risk of a security or portfolio.

**Delta:** estimate of the convertible's sensitivity to changes in the stock price.

**Leverage:** long market value of the portfolio relative to the NAV.

**Merrill Lynch 3-Month Treasury Bill Index:** Consists of U.S. Treasury Bills maturing in 90 days. Indexes are unmanaged and one cannot invest directly in an index.

**S&P 500 Index:** An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

**Sharpe Ratio:** A risk-adjusted performance measure which subtracts the Treasury bill return from the Fund's return and divides the result by the Fund's standard deviation.

An investment in any of the AQR Funds involves risk, including loss of principal. The value of the Fund's portfolio holdings may fluctuate in response to events specific to the companies in which the Fund invests, as well as economic, political or social events in the United States or abroad. An investor considering the Funds should be able to tolerate potentially wide price fluctuations. The Funds are subject to high portfolio turnover risk as a result of frequent trading, and thus, will incur a higher level of brokerage fees and commissions, and cause a higher level of tax liability to shareholders in the Funds. The Funds may attempt to increase its income or total return through the use of securities lending, credit default swaps, derivative, and distressed investments; which may be subject to the possibility of additional loss as a result of these investment techniques. The fund is also subject to the risk that anticipated Arbitrage opportunities do not play out as planned, resulting in losses. Diversification does not eliminate the risk of losses.

Per the prospectus, the Investment Objective of the AQR Diversified Arbitrage Fund is the "Fund" seeks long-term absolute (positive) returns.

**As of today, the most current holdings are as of 12/31/13. For the top ten holdings for the AQR Diversified Arbitrage Fund and a complete list of all AQR Funds holdings please visit:**

**[http://www.aqrfunds.com/Reference\\_Materials/Prospectus\\_and\\_Fund\\_Information/Content/default.fs](http://www.aqrfunds.com/Reference_Materials/Prospectus_and_Fund_Information/Content/default.fs)**

**Holdings are subject to change.**

**An investor should consider the investment objectives, risks, charges and expenses of the Fund carefully before investing. To obtain a Prospectus containing this and other information, please call 1-866-290-2688 or download the file from [www.aqrfunds.com](http://www.aqrfunds.com). Read the Prospectus carefully before you invest. There is no assurance the stated objective(s) will be met. [AQR3089 12-31-2014] © AQR Funds distributed by ALPS Distributors, Inc.**