NEW FRONTIER

Market Perspectives: 2nd Quarter 2014

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

Dr. Richard O. Michaud

President and CEO

New Frontier

Dr. Michaud earned a Ph.D. in Mathematics from Boston University and has taught investment management at Columbia University. He is the co-holder of four U.S. patents and is the author of *Efficient Asset Management* and many professional and academic articles.

Slow but Steady Growth

Markets

In the second quarter of 2014 major asset class performance was positive. The Dow was up 2.4%, the S&P up 4.7%, and the NASDAQ up 5%. International equities nearly kept pace with US equities; the MSCI ACWI ex US was up 3.8%. MSCI Europe was up 1.9%, and MSCI Pacific was up 5.2%. Emerging market equity indices rebounded from recent underperformance to close the quarter up 5.5%. Domestic REITs continued a strong run for the year, with a total return of 7.2% quarter to date, and 18.1% year to date. The Barclays Capital Aggregate total return index was up 2% for the quarter. Despite ominous news out of Iraq, the VIX maintained low levels, ending the quarter at 12, and oil prices edged up 4.4%. The dollar rose 0.8% relative to the euro and fell 0.7% against the yen for the quarter.

Perspectives

The sharp drop of U.S. GDP in the first quarter raised some doubts of the sustainability of the five-year-old recovery. However, the downturn was heavily influenced by a number of one-off factors including severe winter weather in many parts of the U.S. and weak demand abroad. Recently there have been a number of positive signs of economic growth in consumer spending, business investment, hiring, new and existing home sales, and manufacturing output across many industries. In addition, many major indices have hit new highs, interest rates remain remarkably low, and the fear index is at historical lows.

U.S. investors seem to have settled in with the notion of a Fed-dominated capital market. Investors were comforted by the Fed's upbeat economic outlook and commitment to low interest rates and focus on joblessness. No disruption in bond purchasing policy inspired confidence in the basic health of the economy. There is little prospect of a sharp rise in rates that would limit the recovery for some time to come. This is not meant to imply that the Fed's actions necessarily have a dominating impact on valuations. Rather, there is a widespread consensus of Fed policies promoting slow but steady economic growth relative to well calibrated stimulus to key components of the economy. Investor consensus also includes recognition of a relative truce in political dysfunction in Washington and elsewhere that has had a serious negative impact on global economic function in the past.

The Fed report included important insights in current and future policies for managing the recovery. The Fed said that it is testing new ways to control short-term interest rates once it ends the monthly bond buying policy. This will include keeping the size

continued on page 2

About New Frontier

New Frontier is a Boston-based institutional research and investment advisory firm specializing in the development and application of state-of-the-art investment technology. Founded in 1998 by the inventors of the world's first broad spectrum, patented, provably effective portfolio optimization process, the firm continues to pioneer new developments in asset allocation and portfolio selection. Based on practical investment theory, New Frontier's services help institutional investors across the globe to select and maintain more effective portfolios.

More information is available at **www.newfrontieradvisors.com**.

of bond investments about the same by reinvesting in maturing bonds. Fundamentally, the major concerns remain high long-term unemployment and stagnant incomes. In the view of the Fed, signs of inflation are mitigated by the existence of the long-term unemployed and their likely impact on wage and price growth in a strengthening economy. The International Monetary Fund's (IMF) recent annual review report also recommended keeping rates low, warning that the U.S. was not likely to reach full employment until 2017.

The eurozone has spent the year worrying about ultra-low inflation that could push some of the EU economies into deflation. Latest surveys of the Purchasing Managers' Index (PMI) indicate that both the services and manufacturing sectors are declining. In particular German manufacturing grew at the slowest rate in eight months in June, while France's PMI indicated contracting private-sector output. Overall, the European economy is stuck in slow growth gear with investors wondering when the recovery will arrive. In the view of some, growth is so slow that it is even uncertain whether the eurozone is in fact in a prolonged pause or still in recession.

The news is that European ministers appear to be shifting away from austerity and are focusing more on growth, including more flexibility on budget rules. France is moving toward more pro-business policies. The IMF has recently put its support behind more stimulative policies including a bond-buying program of sovereign assets to boost confidence, improve corporate and household balance sheets, and stimulate bank lending. Mario Draghi, the head of the European Central Bank (ECB), has long contemplated large-scale asset purchases if it becomes clear that the eurozone faces a protracted period of low inflation and economic stagnation. However, Europe's indebted households and corporations may not care about cheap interest rates but only of offloading debt. In this case, as happened in Japan, monetary policy becomes ineffective. The root cause may be the conundrum of necessary deleveraging while low inflation reduces the ability to cut prices. The outlook remains slow growth for some time to come.

Emerging market pressures have eased, resulting in recent positive performance. Many countries that were heavily reliant on foreign financing were hit hard given heightened concerns of a near term rise in U.S. rates. Central banks needed to raise rates in order to slow capital flight. Investment flows have since reversed given reduced concerns of rises in U.S. rates. However, many economies are reverting to their prior less sustainable policies and postponing the need for reforms.

Investors should be wary of the many geopolitical risks that haunt the global economy. As recent incidents attest, militarism in Russia, China, North Korea, Syria, and the Middle East can appear at any time and severely limit prospects for global economic growth. Domestically, recent revelations of abuses in dark pool and high

continued on page 3

New Frontier Portfolios

New Frontier develops and manages a broad range of ETF-based asset allocation portfolios for advisors and their clients, and currently oversees over $1 billion in global ETF asset allocation portfolios.

frequency trading have implications for major overhauls in regulations. However, it is worth noting that New Frontier's low turnover and liquid analytical strategies are least affected by such trading abuses.

Look Ahead

The U.S. market has hit new highs and has completely recovered from its lows in March 2009. While not a period of uninterrupted economic and political calm, the bull market has been surprisingly robust and consistent since the summer of 2011. Investors may reasonably ask, what are the signs for the next correction? While unforecastable geopolitical issues are always a consideration there are many signs of continued expansion. The market currently has limited volatility. Relative valuations are within normal ranges in many cases. Sentiment is a positive indicator; the rally is hated and distrusted, a good sign of continuation while many retail investors are in cash. Recently, mergers and acquisitions activity has been robust. Yields are likely to be low and stable for some time.

In the U.S. and Europe, financial reforms including mandated bank stress tests and regulations for increased reserves have contributed to enhanced transparency and reduction in the risks of unfettered and often reckless credit leveraging by banks. But, the unintended consequence is that banks are increasingly disintermediated and constrained in their role of corporate lending from having to bolster their capital ratios. Bank disintermediation has increasingly led corporations to bond markets. In addition, startups and technology have provided many routes of disintermediation relative to banks' traditional role. But bond funds without liquidity buffers could be subject to a run by investors and cause significant collapses of capital markets.

Shadow banks, such as bond funds, represent financial entities that provide credit outside the regular banking system. Shadow banks were major contributors to the fragility and instability of capital markets in the run up to the Great Recession. They remain a major concern of proposed reforms of the global financial system. Here in the U.S., Fed officials have discussed imposing exit fees on bond funds operating as shadow banks in order to avoid a run by investors. More generally, the G20 continues to focus on reforms of the shadow banking system.

Shadow banking issues are currently acute in China. The economy is in the midst of a dangerous credit bubble. While shadow bank products have contributed to its biggest credit boom in its history, China's enormous and poorly regulated shadow banking sector has started to run into trouble. The near default of many Chinese local government financing vehicles has caused great alarms in and outside China. Even products yielding 9% or more are selling poorly or not at all. The sector has become so big that it has the potential to destabilize the entire system. There is

continued on page 4

serious risk that China's investment-reliant growth could come to a sharp end. The central government will likely have to step in to facilitate restructuring but the holders of these high-interest trust products will likely lose money. The moral for investors is that global capital market fragility is far from cured.

While the market has fully recovered and has reached new highs, many retail investors are afflicted with market regret and have remained on the sidelines. At the same time, many institutional investors have had their own version of market regret by experimenting with non-standard asset allocation investment frameworks. In many cases, pension funds, endowment funds, and foundations implemented variations of the Yale endowment model, dramatically reducing equity and bond allocations in favor of private equity, hedge funds, and alternatives. Unfortunately, in too many cases, the experiments have not been successful compared to more traditional methods. Private equity often has seemed like equity with high fees, hedge funds after fees often had limited returns, and alternatives often did not perform as expected. Effectively diversified global asset allocation properly defined to meet long-term goals and liabilities has often been the investment-efficient optimal strategy.

One interesting indicator of investor sentiment is that the number of outstanding option contracts that profit from a rise in VIX futures is hitting all time highs. Many traders are betting that the market has become too calm and that volatility is overdue for a spike. But, so far at least, those betting on swings have been losing money. Some lost nearly 32% since the start of the year. In addition, the Fed has been concerned that unusually stable markets may induce risk-taking behavior and excess leveraging that could pose risks to financial stability near-term. The key question for investors is whether slow but positive U.S. growth and beneficial Fed policies will keep a lid on asset-price volatility or that record stock index levels and high bond prices spell trouble for the future. It is the wise investor who continues to monitor and rebalance their drifted portfolio in the most optimal and trade-effective manner.

Recent New Frontier Research Presentations

New Frontier's Dr. Richard Michaud conducted an interview with Nobel Prize winner Dr. Harry Markowitz at the *Journal Of Investment Management* conference that inaugurated the Markowitz Prize in March 2011. In the interview, Dr. Markowitz traces the evolution of his seminal work in modern finance, including his contributions to rational behavioral and computational finance, the great debate with Paul Samuelson, and his recent innovations. New Frontier now presents a subtitled video of the interview for scholars and admirers of an essential pioneer of modern finance, available at www.newfrontieradvisors.com. In addition, New Frontier submitted our testimony to the effect that the Department of Labor should disallow blanket

continued on page 5

fiduciary relief for target date funds as qualified default investment alternatives. The testimony, available at blog.newfrontieradvisors.com, references our analysis of target date funds published this winter in the *Journal of Indexes*.

July 7, 2014