



## 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.

## On Cruise Control

### Markets

The first quarter was a relatively calm start to the year. The Dow was down 0.7%, the S&P up 1.3%, and the NASDAQ up 0.5%. International equities were nearly flat as well with the MSCI ACWI ex US down 0.1%. European equities were up 1.5% and Pacific equities were moderately negative, with the MSCI Pacific down 3.3% for the quarter. Emerging market equity indices were down 0.8% for the quarter, with China down 6.7%. Benefitting from the positive potential of duration, the Barclays Capital Aggregate Total Return index closed the quarter up 1.8%. Gold bounced back from a tough 2013, up 7.2%. The VIX rose mid quarter but eased lower to settle at 13.9% as the quarter closed. The dollar rose 0.4% relative to the euro and declined 2% against the yen for the quarter. All of New Frontier's portfolios are up year to date, the global strategic ETF portfolios total returns are 1.2% to 2.7% depending on equity exposure. All four of New Frontier's lower risk strategic portfolios beat both the S&P 500 index and Barclays Agg and all six beat MSCI ACWI.

### Perspectives

The first quarter of 2014 was the calm that settled over equities after the storms of 2013. Looking back, many 2013 risk factors and uncertainties had been resolved by the turn of the year. Political dysfunction was resolved at least temporarily based on a tentative domestic political truce, and important uncertainties in macroeconomic monetary policy had run their course. Politically, federal credit default was moved off the table for the next two years and a reasonable though minimal bipartisan federal budget was passed. The Federal Reserve Board of Governors Chair was handed off to Janet Yellen with minimal controversy. The Fed's tapering policy for quantitative easing continued with little change in policy directives or perspectives.

The domestic economic environment and U.S. capital markets seemed on cruise control. Signs of modest, even grudging, but consistent economic growth have been positive for many months. Non-farm job growth has been running about 200,000 in 2014 with a robust pattern across economic sectors in spite of bad weather. Fixed income seems to be in a relatively normal functioning state. The 10 year Treasury rate has hovered around a relatively normal long-term rate of 3% given current inflation. Though sensitive to geopolitical factors, the Treasury market reflects undiminished global confidence in the dollar as the safe haven currency of choice. Interest rates are low and the Fed remains accommodative. Fed tapering policy is relatively a non-issue at this point. The recent U.S. bank stress test results indicate, with exceptions, a healthy robust banking system far better able to weather systemic stresses as well as

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## 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](http://www.newfrontieradvisors.com).

a clearing of the books of hidden risks. While many may have not paid attention, long-term U.S. Treasuries provided the highest return of most major asset classes for the quarter.

The news from Europe, on balance, is mixed. The ongoing stress tests of European banks are doing much to clear the air of hidden risks and to enhance capital accounts. Another positive sign has been the establishment of the resolution trust that gives the ECB the power to police lenders and to wind down banks with a rescue fund in necessary. The euro is in no danger of failing anytime soon. A new sense of urgent concern on the value of the euro, inflation, economic growth and unemployment pervades recent policy statements from the ECB. The most immediate concern is deflation. But even with more proactive political will, a QE policy will not be a simple process for the ECB. In contrast to the Fed, there are no universal eurozone bonds to purchase. Any discussion of eurozone-wide backed bonds has been a political non-starter up until now. Nevertheless, Mario Draghi is a highly competent technician with a willingness to use tools as required.

China's credit-fueled economic growth policies have led to a buildup of debt that has afflicted the entire economy. Manufacturing indicators point to a serious economic slowdown while the government signals a major shift towards encouraging domestic spending relative to export oriented growth. Banks have been under a lot of pressure as a result of decelerating growth. The five biggest state-owned banks have stepped up efforts to write off bad loans. A weakening yuan has reduced speculative capital and discouraged the carry trade. The financial health of many Chinese corporations, the bursting real estate bubble, and the instability of the shadow banking system are all sources of worry. Defaults seem all but inevitable. But, China is pushing ahead with wide ranging financial overhauls. While economic difficulties may result in significant asset volatility, China remains a very wealthy country with much flexibility to adjust the spigots of credit to promote economic and market stability.

There are serious geopolitical risks that continue to affect and limit global economic growth. The destabilizing consequences of Chinese, North Korean, and now Russian nationalism and militarism are impossible to forecast. The FOREX inquiry of LIBOR rigging at major banks has yet to run its course. The threat of religious and cyber terrorism remains a continuing source of global instability. The Abe economics experiment in Japan enters a new riskier phase for enhancing liquidity. Questions remain on the sustainability of economic growth in many countries with rigid social structures and aging demographics. Recent revelations in high frequency trading (HFT) have implications for major overhauls in brokerage regulations. Note, however, that New Frontier's low turnover and liquid analytical strategy is least affected by recent HFT issues.

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## 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.

## Look Ahead

Many investors are currently afflicted with “market regret” disease. Spooked by the great 2008 meltdown, they cashed out and watched from the sidelines while the market, including a 32% return in 2013, tripled beginning in March 2009. Others may have invested in exotic low risk strategies that often did not meet objectives or even succeed in preserving capital.

With indices near historical highs and yields near historical lows, many media pundits and strategists warn of markets running out of gas, major corrections, and systemic risks. Investors may want to note that it is often the same forecasters that opined dire warnings of cataclysms in 2009, and more recently at the beginning of 2013, all in the context of one of the greatest bull markets in financial history.

A basic understanding of the principles of capital market functioning can limit the damage to investors’ financial health. Effective long-term investing requires patience, a well thought out core-satellite investment plan, and avoiding fashionable but unreliable investment strategies. Over the long term, markets are not irrational. Capital markets are driven by the overall health of the economy and its ability to be competitive and attract capital. Swings in basic economic value tend to be slow moving. While political dysfunction can do much harm, domestic and global macroeconomic fundamentals, in addition to innovation, are the main drivers of capital values. Whipsawed investors should learn that managing long-term investing risk requires effective diversification relative to a well-chosen level of systematic risk.

Long-term historical capital market data can be a valuable source of evidence for the benefit of long-term investing principles. Credible historical data for the S&P 500 index and short-term U.S. interest rates is available from 1926 to the present. Over this period, the S&P index returned an average of 11% with a standard deviation of 20% while short-term rates averaged 3%. This nearly 90 year record of the functioning of major capital markets includes periods of two world wars, a global depression, multiple major military conflicts, the cold war, high inflation and recessionary periods, medical epidemics, and much political dysfunction. While no one can predict the future, the historical record should provide testimony to the robustness of capital markets and the likely benefits of thoughtful long-term investing.

The record shows that New Frontier investors did not suffer from market regret. New Frontier continuously monitors domestic and global macroeconomics and political trends. We were convinced that the monetary macroeconomic and fiscal and regulatory machinery in place, in addition to the fundamental strength of the American economy at the turn of 2009, were likely to overcome over time the harm caused by the meltdown. It is also worth stressing that New Frontier’s investment

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strategies are fundamentally different due to our unique patented investment technologies. In particular, Michaud optimization is the only procedure with a rigorous statistical proof of enhanced investment effectiveness. Michaud optimized portfolios exhibit a very rich unique level of diversification. More effective diversification is a key factor in New Frontier's long-term performance and our ability to weather financial storms over time.

## Recent New Frontier Research Presentations

David Esch and Robert Michaud published their paper, "The Failed Promise of Target-Date Funds," in this winter's edition of *Journal of Indexes*. David presented this research to QWAFEFW New York on March 25. Robert Michaud participated on a panel, "Total Returns: Accessing Dividend Strategies through ETFs," at the 7th Annual Inside ETFs Conference, January 26-29 in Hollywood, Florida. Richard Michaud, David Esch, and Robert Michaud presented their paper, "Deconstructing Black-Litterman: How to Get the Portfolio You Already Knew You Wanted," published in the *Journal Of Investment Management*, 2013, on January 16 at the first joint meeting of the New York Society of Security Analysts (NYSSA) and Society of Quantitative Analysts (SQA), on March 14 to the Financial Statistics & Risk Management (FSRM) Program at Rutgers University, and on March 24 at the Boston Security Analysts Society. Richard Michaud presented New Frontier's research on portfolio rebalancing, "Portfolio Monitoring in Theory and Practice," published in the *Journal Of Investment Management*, 2012, at the Society of Actuaries (SOA) Investment Symposium on March 17 in New York.

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