NEW FRONTIER

# Market Perspectives: 4th Quarter 2013

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.

## A Healing Economy

### Markets

The quarter continued the theme of the year, with U.S. equities continuing their dramatic performance. For the quarter, the Dow was up 9.6%, the S&P 9.9%, and the NASDAQ 10.7%. The year's returns substantially exceeded last year's "expert predictions" and much of this year's punditry with the Dow up 26.5%, S&P up 29.6%, and NASDAQ up 38.3%. International equities were marginally positive for the quarter and year with the MSCI ACWI ex U.S. up 1% this quarter but up 13% this year. Emerging market equity indices were up 1% for the quarter but remain down 8% for the year. China continued a nice turnaround for the year with the China ETF in New Frontier's portfolios up 6% for the quarter and positive 8% for the year. Fixed income indices have been mixed for the quarter and year. The Barclays Capital Aggregate Total Return bond index is flat for the quarter and down 2% for the year. It has been a tough year for gold, as the precious metal is down approximately 27%. The VIX maintained low levels for the quarter to close the year at 13.7%. The dollar declined 1.8% relative to the euro this quarter and was down 3.9% for the year. The dollar rose 7.6% against the yen for the quarter and was up 22.5% for the year. New Frontier's global strategic portfolios total returns were up 0.8% to 6.9% for the quarter and up 2.5% to 22.5% for the year depending on equity exposure.

### Perspectives

In spite of some market pundits' predictions in early 2013 that emerging markets were a great opportunity while the U.S. was dangerous, with markets nearing "all-time highs," it was a very good year to own U.S. equities. It was hard to argue that the much questioned Federal Reserve's stimulus program has not been effective given the U.S. unemployment rate falling to 7% in November, a five year low, job creation per month running at 200,000 since August, inflation running about 1%, and major equity indices hitting new highs. In the last meeting of the year of the Federal Open Market Committee (FOMC), Chairman Ben Bernanke announced a tapering of the bond purchasing program of $10B per month and an open ended cautiously optimistic assessment of the state of the U.S. economy. The Dow Jones industrial average rose 180 points at the announcement.

The good economic and market news came with a backdrop of intense partisan politics and unhelpful fiscal events. The most important economic event occurred at the beginning of the quarter with the federal government shutdown on October 1. In a significant political miscalculation, the shutdown vote by the Republican-led House

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 Representatives resulted in 800,000 federal employees being put on indefinite unpaid leave with knock on effects throughout the U.S. and world economy. A two week shutdown was estimated to reduce GDP growth by 0.3 to 0.4 percent, a non-trivial factor for a slowly healing economy. In addition, the House's refusal to raise the federal debt ceiling threatened the status of the dollar as the global reserve currency of choice with unknown, possibly catastrophic, economic consequences. A compromise was reached in mid-October with only hours to go before the federal debt limit was reached. Subsequently, the partisan wars relented a bit resulting in a modest, but useful, two year compromise budget bill that moderated draconian budget cuts from the Sequester and defused the likelihood of another government shutdown any time soon.

The long-awaited Federal Reserve December tapering announcement arguably represents a turning point for many global capital markets. A level of uncertainty has been removed from U.S. monetary policy. The taper is a signal of a macroeconomic consensus that U.S. economic growth is likely to be sustainable. Interestingly, the taper announcement itself was so widely anticipated that it had a relatively limited effect on fixed income investments.

The global economy remains susceptible to many geopolitical risks. While some economic news from the eurozone has turned positive, unemployment is unsustainably high, and most European Union economies continue to experience anemic economic growth. The question whether the eurozone can remain intact is still an open issue. Politically difficult structural reforms required for sustainability and growth have largely been ignored. The Resolution Trust agreement for bringing the banking system under one set of rules is still very much a work in progress. China has political and economic issues it needs to resolve. The economy is overleveraged, and a large shadow banking system is making the economy unstable and hard to manage. Chinese and North Korean nationalism and militarism are serious global economic destabilizing factors. The threat of religious and cyber terrorism remains a constant source of instability for the global economy. On the other hand, one area of positive news comes from Japan. The Japanese macroeconomic and fiscal policies known as Abenomics appear to be shaking the economy out of the spiral of deflation. The equity market has responded dramatically with the Nikkei 225 rising 56%. Questions remain on sustainability going forward considering Japan's rigid social structure and aging demographics.

## Look Ahead

It is worth reflecting at year end on what has been learned from the Great Recession. What were the effective policies and the unhelpful policies employed

*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.

to manage the meltdown and restart the economy? What can such understanding tell us about where we are and where we might be headed?

The last five years have seen extraordinary U.S. monetary macroeconomic interventions. The Bernanke-led Federal Reserve's stimulus spending policies were, for many, inconsistent with common sense. It is natural for many individuals to think that spending should be reduced in difficult times. Many market strategists were skeptical of the value of the Fed's policies. Memorable novel concepts such as secular stagnation and static disequilibrium were being used to warn of possible risks to equity markets.

A thoughtful understanding of modern monetary macroeconomics is useful in parsing the static in the pundit and media universe. A perspective different from conventional is required. Money's purpose is simply to facilitate commerce. At the government level, a stimulus program can be used to prime a stalled economic pump. Government spending by the Federal Reserve can be a last resort when business activity is moribund, as it was after the meltdown and for much of the last five years. The key issue was not whether to provide stimulus but rather how to carefully calibrate the amount and target of liquidity in the economy for optimally encouraging economic growth and employment without spurring inflation relative to domestic fiscal policies and global economic issues.

Inevitably, the Federal Reserve's bond buying program will end. With yields rising inexorably and prices falling, why invest in bonds at all? The primary role of bonds in New Frontier's strategic asset allocation portfolios is not price appreciation per se but management of portfolio risk at a given level of systematic risk. Although historically stocks beat bonds seventy percent of the time, few managers counsel investment solely in equities. Bond investing is similar to buying an insurance policy that provides an anchor to windward for moderating portfolio volatility in periods when equities are out of favor. Since compound return is negatively affected by portfolio volatility over time, an appropriate level of bond risk will often provide enhanced long-term portfolio return. This basic principle validates the importance of effective diversification technology and the value of identifying an investor's long-term investment goals with an appropriate level of stock/bond systematic risk.

The U.S. equity market was a dominant performer for the quarter and year. Even perennial bulls were surprised at the robustness of U.S. equity markets. It is always tempting to overweight best performing assets when formulating an investment policy. However, investors should note that the high performing asset in one period is seldom persistently so in future periods. Investors may want to remember

*continued on page 4*

that gold was a dominant return asset in the recent past. Given the size of the run up, it would not be very surprising to experience more limited returns and periods of downturns in 2014. Investors are well advised to consider the historical evidence of the benefits of globally well-diversified strategic portfolios for meeting long-term objectives.

It is important to note that effective diversification is a necessary condition for enhanced long-term return. Not all asset allocations are very well-diversified. Traditionally optimized portfolios are often dominated by a small number of assets. New Frontier's patented Michaud optimization is globally recognized for producing more investment effective diversified portfolios. It is the only optimization technology with a mathematical-statistical proof of enhanced out-of-sample investment effectiveness. Effectively diversified portfolios are an important factor in the success of New Frontier's investment strategies.

Strategic investing is necessarily patient investing and focused on underlying long-term economic and market fundamentals. In contrast, the volatility in capital markets in the last five years has encouraged the development and marketing of many exotic strategies for avoiding equity downside risk. Many investors may have been whipsawed attempting to follow various strategies that have often been ineffective and done more harm than good. Innovation is the ultimate source of all economic value in capital markets. Patience at an appropriate level of systematic risk with effective diversification tends to be the most reliable route for meeting long-term investment objectives. While staying the course may be difficult and not very exciting, it is more often than not the optimal long-term investment policy.

Volatile markets can be useful for highlighting regulatory issues often ignored in more stable times. A key concern motivated by the Great Recession is better regulation of advice for investors. Regulators typically hold firms rather than individuals accountable for failures of investment funds marketed to clients. Individual brokers claim that they cannot be responsible for understanding complex investments endorsed by their firm. Recently the Financial Industry Regulatory Authority (FINRA) has said that individual brokers must do more to act in their client's best interest. Many investment products are so complex it is hard to believe investors understood what they were buying or brokers and advisers what they were selling. The risks of many complex and novel strategies, particularly those dependent on derivatives, are difficult to anticipate by their developers, never mind by an average broker or adviser. One FINRA proposal is to limit the ability of individuals to sell a product if they are unable to understand or explain the risks. If the concept of limiting a broker or adviser to selling products of which

*continued on page 5*

they can clearly communicate the risks to investors, it will be a fundamental change in the investment industry. The importance of transparency as well as diversification may become a key issue. For many, it will be a much welcome step in enhancing the investment advice that investors receive.

## Upcoming and Recent Research Presentations

David Esch and Robert Michaud have published their paper on "The Failed Promise of Target-Date Funds," *Journal of Indexes*, January/February 2014. Robert Michaud will also be presenting 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 will be presenting their paper, "Deconstructing Black-Litterman: How to Get the Portfolio You Already Knew You Wanted," published in the *Journal Of Investment Management*, 2013, at the first joint meeting of the New York Society of Security Analysts (NYSSA) and Society of Quantitative Analysts (SQA) in New York on January 16. Richard, David, and Robert will also present their paper on Black-Litterman on March 24 at the Boston Security Analysts Society. The paper was also presented in October to the CFA Society of Houston, the CFA Society of Fort Worth, and the CFA Society of Dallas and in November to QWAFAFEW Princeton. Robert Michaud presented his research on "The Riskiness of Low Volatility Investing," at QWAFAFEW New York in November. Richard Michaud will be presenting New Frontier's research on portfolio rebalancing, "Portfolio Monitoring in Theory and Practice," published 2013 in the *Journal Of Investment Management*, to the Society of Actuaries (SOA) Investment Symposium March 17 in New York.

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