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Teachings from Recovered Markets

Domestic equity markets continued to confound many strategists and pundits. The Dow, S&P, and NASDAQ ended the quarter at all-time record highs. The Dow was up 11.3%, the S&P 10.0%, and the NASDAQ 8.2%. For globally diversified equity investors, the news was mixed but still positive. Emerging markets were down, but developed markets made modest gains. In all, the ACWI ex US was up a mere 2.3%. For the second quarter in a row, the Barclays Capital Aggregate bond index was flat. The VIX remains at very low levels; gold declined modestly while the dollar gained 3.1% against the euro and a striking 9.3% against the yen. New Frontier's global strategic model portfolios rose appropriately relative to assumed systematic risk but underperformed domestic equities due to global diversification. There were interesting pockets of performance internationally with the Swiss index up 11.2% and the Japanese index dramatically up nearly 20%. In a strong investing environment of recovering equity capital markets many investors may have missed the recovery.

Perspectives

Domestic indices' all-time record highs indicate that U.S. domestic equity markets have largely recovered from the 2008 Great Recession. It may have taken four years but it still seems a remarkable achievement given the Dow's low of 6620 in March 2009. It is worth noting that prior highs were attained in an era with a poor savings rate and wide use of levered strategies. The last four years were widely characterized by a "low return" market mantra and fear of equities stoked by many doomsayers, pundits, and strategists who greeted every upturn with pessimism. It was the season of investment fashions and fads promoted by investment banks and asset managers with buyer-beware risky and/or ersatz low risk and return strategies. In terms of the old adage, the markets nicely climbed a wall of worry.

Questions naturally arise about market timing and being invested at an "all-time high". It's worth noting that historically, returns have been quite reasonable over both short and long term horizons for investors starting from an "all-time" high. Objective investors should generally neither increase nor decrease their market participation based solely on the market level.

There were, of course, real headwinds in the U.S. economy and beyond during this period. Too much political posturing and too little real economics characterized Washington discourse that was eagerly promoted by a sensation seeking media. The long-running euro saga continued to hang over global markets with unforeseeable consequences. Mario Draghi's welcome announcement that the euro is irreversible calmed

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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.

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markets, but few were as certain as the rhetoric suggested, particularly with respect to economies on the periphery of the eurozone such as Cyprus, Slovenia, and Greece.

Economic growth continues to be burdened by political dysfunction and uncertainty. The federal government's budget sequester of blind cuts in spending is clearly not conducive to encouraging economic growth. The effect will have many economic disruptions, some trivial but also some possibly crippling the economic recovery on the way. It is clearly not in the economic best interests of the nation.

The Cyprus bank collapse and the resulting need for a European Union bailout is a stark reminder of the arduousness of the road ahead for the eurozone. While Cyprus is a small, almost insignificant, economy that largely functions as a tax haven and money launderer, it is nevertheless part of the eurozone. The uncertainty surrounding the decision making process concerning support from the European Union fundamentally threatens the European integration project. A Cyprus whose best recourse may be to leave the euro would violate the promise of the European leaders to ensure the integrity of the eurozone no matter what. Leaving the eurozone would be likely to set off a chain reaction including bank runs in other members, particularly in the weakest ones, such as Greece. If any one country finds it necessary to leave the euro, the potential will now exist that anyone can.

Another fundamental issue for the eurozone is economic weakness. The eurozone has been in recession for five quarters and forecasters predict two more. Unemployment is at an unsustainable double digit level and more than 20% in some economies. Even the German economy may be dipping into recession while many others are already in recession. The austerity programs that comfort the high morality of some northern European political leaders seems to have little positive economic value. The fact that German banks can borrow at near zero interest rates and lend to other troubled economies at much higher rates raises fundamental questions of the fairness implicit in the economic structure of the eurozone. The euro limits what eurozone economies can do in a downturn and the ECB does not have the tools available to the Federal Reserve. The long-term success of the European Union requires more structural changes in fiscal and monetary policies and near term robust U.S. and Asian economic growth.

The U.S. report from the Senate Permanent Subcommittee on Investigations into J.P. Morgan Chase's trading loss of an estimated 6.2 billion dollars raises fundamental banking regulatory issues and questions of systemic risks and the stability of global capital markets. The report and hearing at the end of March left no doubt that recklessness tied to derivative speculation still pervades the banking system and still puts the public at risk. Bankers are not acting cautious or chastened from the 2008 meltdown. Regulators continue to be duped and docile. The bet soured, the bank ignored the risk, the losses piled up, and the bank misled investors and the public and withheld information from regulators. All of this from the U.S.'s biggest and most

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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.

highly respected bank with a highly respected CEO. For a bank as profitable as J.P. Morgan, the loss was manageable this time, but the question of recurrence is extremely troubling. The report makes clear there was a truly frightening lack of oversight and even of internal understanding of what was going on. A smaller, less profitable bank may have had to fold, raising memories of the investment banking failures in the run up to the Great Recession. Even if there were findings in the Senate report that justified criminal prosecution, the Justice Department has taken the position that the banks are too big to indict because prosecution could destabilize the financial system. The problems of too-big-to-fail banks are still here. It is not just a U.S. but an international problem, and it is one that requires international rules and regulations. Otherwise risky derivative speculation would just move to more favorable domiciles while leaving the risk to be borne by the many. So how strong is the political imperative in Washington to do something about all of this? The Chairman of the U. S. Senate Subcommittee on Investigations, Carl Levin, Democrat from Michigan, was waging largely a lonely battle. In the hearing, with a couple of exceptions, many senators, Democrats and Republicans, hardly bothered to show up. Should anyone feel reassured? The Senate report clearly indicates that the financial system is little less at risk than four years ago. The regulatory limitations of the 2008 meltdown are far from resolved. Further essential reforms are necessary though, seemingly, unlikely any time soon.

Look Ahead

The U.S. economy has important positives for the future. The presidential election is over and the beginning of a strange political truce seems to be taking place in Washington. Neither party will want to take the blame for a politically motivated downturn in the American economy. In addition, it is clear that indulgence of Washington squabbling and political calculation and even media interest is reaching some ending point.

The Federal Reserve under Chairman Bernanke continues to provide thoughtful watchfulness for the state of the economy. QE3 continues to pump eighty-five billion dollars per month of purchases of mortgage backed securities and longer term treasuries into the U.S. economy. The Fed remains resolute in maintaining low interest rates for the reasonable foreseeable future. While unemployment remains intolerably high for a well functioning economic system, the trend for lower unemployment seems to be in place. While many cash rich, highly productive U.S. corporations remain tentative, housing construction and prices continue to improve, and the wealth effect of rising stock values may be related to the fact that consumer spending seems not to be overly affected by the negative effects of the budget sequester. The average forecasts of economists have increased from 1.5% to 2.3% for the year. Interestingly, the fourth quarter growth in GDP was revised from negative to a positive 0.4%.

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Asia remains fundamental to the growth of the global economy. The news from Japan seems positive in a refreshing way. It has been a long time in coming if it is. Certainly the rise in the Nikkei is a positive indicator of potentially better times ahead, even when considering the decline in the value of the yen. China remains a question mark with near term weaknesses though hardly long-term. South Korea is emerging as a major global economy. Asian economies remain an important part of increasingly connected global capital markets and economies.

One major risk is the resolve of the eurozone for addressing its multifaceted issues. It is in everyone's interest that the European integration project succeeds even if significant modifications are required. Economies like Cyprus that function largely out of the regulatory process need to be reined in or let loose without the promise of support.

Additionally, the problems in the Middle East continue to fester. Even as the U.S. leaves Afghanistan, the problem of fanatical terrorism is not resolved. More recently the world woke up to the dangers of a North Korea with nuclear capability, long-range missiles, and an inexperienced ruler claiming the capability and possible intent of a nuclear warhead aimed at the U.S. as revenge for promoting U.N. sanctions. The world has rarely and for any length of time been at peace. But the interconnectedness of global economies raises the ante and risks for everyone.

The last four years have taught hard lessons for many investors. Too often basic principles of long-term investing were dismissed as stodgy and out-of-date by investment banks and managers promoting new, often more profitable, strategies. Few, if any, managers have sustainable expertise in timing markets and making bets where successes outweigh the failures over time. The Norwegian model for asset management provides an important counter-example relative to fashions and speculative strategies. As Samuelson reminds us, "Investing should be as exciting as watching grass grow or paint dry. If you want excitement go to Vegas." The last four years teach the importance of a core strategic global strategy, one that is always in the market, systematic risk appropriate for an investor's long-term objectives, and effectively diversified, as an integral part of any well defined investment program.

Research News

The paper "Deconstructing Black-Litterman: How to Get the Portfolio You Already Knew You Wanted," by Richard Michaud, David Esch, and Robert Michaud, is now published in the *Journal Of Investment Management*, 1st Quarter 2013. In this important paper, we conclude that the Black-Litterman procedure has essentially no investment value for practical asset management. Our research is a serious challenge to academic teaching where Black-Litterman optimization has often been a standard for nearly twenty years.

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Moreover, the procedure is referenced in many papers in academic and professional journals and used to manage hundreds of billions if not trillions of dollars in current asset management globally. We have presented our research in Chicago and New York and will be presenting the paper at the CFA UK institute in London on April 9, 2013. An authorized download of the paper is now available on our website: www.newfrontieradvisors.com. An Executive Summary is also available.

We also note that the paper “Portfolio Monitoring in Theory and Practice,” by Richard Michaud, David Esch, and Robert Michaud, has been published in the *Journal Of Investment Management*, 4th quarter, 2012. An authorized download of the paper is also available on our website: www.newfrontieradvisors.com. This multi-patented process is the basis of the second signature innovation of the firm. It is the first practical procedure for rigorously deciding when trading is advisable, avoiding trading in noise but recommending trading when effective. We have found it an essential component of our asset management process. It is customizable to investment styles, risk aversion, investor horizon and other important considerations of practical asset management.

Richard Michaud’s book review of “The CAPM in the Twenty-First Century” by Haim Levy, 2011, is recently published in *Quantitative Finance*, March 2013. A pre-publication manuscript is available on our website. The review addresses Prof. Levy’s effort to reconcile CAPM theory with Kahneman-Tversky behavioral finance relative to alternative rational decision making frameworks and asset management in practice.

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