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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.

Politics vs. Economics

Domestic equity indices were down modestly for the quarter with the Dow down 2.5%, the S&P 1%, and the NASDAQ 3.1%. However, for the year, domestic equity markets were up nicely with the Dow 7.3%, the S&P 13.4%, and the NASDAQ 15.9%. For globally diversified equity investors, the news was even more favorable. The MSCI's European Index was up 7.0% for the quarter and 19.1% for the year, while MSCI's Pacific Index went up 5.9% for the quarter and 14.4% for the year. Barclays Capital Aggregate bond index was flat for the quarter but posted a 3.8% return for the year. The VIX remained at low levels though it rose a bit ominously at the end of the year reflecting politically induced uncertainty relative to the fiscal cliff. For the quarter, the dollar declined slightly relative to the euro but increased 10.5% relative to the yen. New Frontier's global strategic model portfolios benefited significantly from international diversification and beat standard domestic benchmarks particularly on a risk-adjusted basis. All of the ETFs used by New Frontier posted positive performance for the year. In contrast, hedge funds underperformed the S&P for the fourth year in a row, with an average of 5% for 2012. The excessive search for yield led many investors to exotic buyer-beware risky assets unlikely suitable as long-term investments.

Perspectives

The major news of the quarter was that a fiscal cliff deal passed in the final hours of the 112th Congress and was signed by President Obama. The deal averts tax increases on most Americans and prevents large indiscriminate cuts in spending in many government programs. It also averted, by nearly universal consensus among macroeconomists, tipping the American economy into recession with attendant global implications.

Wall Street forecasts for 2012 were often wildly off the mark. Fiscal cliff and presidential and congressional election politics as well as the fate of the euro hung over much of the year. Zombie economics and hyped doomsday scenarios provided convenient fodder for media and political hacks, inducing fear of equities in many investors. The domination of macroeconomic principles by political agendas can be understood as defending the political, corporate, and special interest status quo. Stasis as a consequence of extreme partisanship raised serious questions concerning whether the American political system is fundamentally flawed and incapable of dealing effectively with major economic crises.

In Europe, politically based economic uncertainty was no less dire. Few gave Greece any chance of staying in the euro, and a domino effect could lead to very serious unknown economic consequences. Austerity policies

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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.

were sliding the eurozone into recession. Globally, China went through a ten year cycle of changing leadership amid widespread concerns of corruption, environmental neglect, and slowing global economic growth. Japan was in the process of major changes in political and economic policies. Through the year there was an undercurrent of global market manipulation and financial scandals that included Libor, money laundering, and excessive derivative risk taking.

The end of the year found that the worst of the predictions did not become reality. The November presidential and congressional elections helped resolve uncertainty concerning mandates for continuation of domestic stimulus and monetary policies. The Affordable Health Care Act was affirmed by the Supreme Court. The American economy reflected slow but steady economic growth and reductions in unemployment levels. The U.S. housing recovery continues. In Europe, leaders demonstrated an absolute commitment to supporting the euro. In particular, the ECB President Mario Draghi affirmed that the euro is "irreversible," earning him the accolade of "Man of the Year" by the *Financial Times*. In a huge concession, Europe appears to have committed itself to a banking union and a European supervisor of the eurozone's largest banks. This will result in a large transfer of national authority to the ECB. Even Greek default probability moderated. In China, the political and economic transition occurred relatively smoothly. In Japan, Mr. Abe's election implies more aggressive fiscal and monetary stimulus policies. For most of the year the VIX indicated moderate market risk levels. Late word provided solace that the most serious issues of tax increases, deficit reduction, unemployment benefits, and Medicare fees that could have led to recession were largely resolved or postponed.

Look Ahead

The last minute fiscal cliff compromise is a relief for domestic equities and a modest positive for the future. Though expiration of the 2% payroll tax credit will not be helpful, consumption is likely to be hit in only a minor way. The deal also represents a small step in addressing the long-term deficit and sovereign debt problems.

It is easy to see the global economy as a half-full or half-empty glass. While the 2012 doomsayers were wrong, there remain many challenges ahead. In Europe, most countries are in recession, and unemployment is unsustainably high. The Greek problem has moderated, but it is not resolved. Spain may or may not require a full bailout. Italy may be entering into a renewed period of instability. Large-scale demonstrations against the austerity policies of the eurozone raise the possibility that the social fabric of the European community is in danger of falling apart. In the U.S., lost productivity in the labor market, the need for continuing stimulating economic growth, and

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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.

proposals for severe spending cuts represent major challenges to the economy. The end-of-year fiscal deal still leaves open politically incited budgetary brinkmanship with much danger of recession-inducing policy mistakes, and severe convulsions in credit markets, including a potentially catastrophic downgrade of U.S. debt.

On the half-full side, many U.S. corporations are cash heavy. Resolution of tax policy uncertainty may help encourage firms who have remained on the sidelines. There is less volatility in capital markets because there is less gearing, a consequence of major regulatory changes that have occurred and continue to be implemented in domestic and international markets. The U.S. Fed continues to innovate with policies linked to reducing unemployment. The level of savings rate is up, and the housing crisis is slowly resolving. Indeed real estate activity has been positive for some time. The sale of the last remaining GM shares held by the U.S. is a comforting sign of a slowly healing economy. The emerging accord on the eurozone banking union has significantly moderated uncertainty of the euro and the eurozone debt crisis. The political transition in China and in Japan appears to be viewed positively in global markets.

Manufacturing Out-Sourcing and Asset Management

Recent discussion on the effects of manufacturing out-sourcing has focused not only on scarring the country's manufacturing workforces but also dimming the capacity to innovate and reducing long-term economic growth. This is because innovation can't be easily separated from production. The loss of collaboration between artisans and engineers can significantly limit value-added improvements, product-life extensions, and cost reductions.

It is of interest to note that the same effect occurs in asset management. Asset managers are "engineers" who develop policies and ideas that are converted to portfolios using methods and data out-sourced to "artisan" technology providers. There is often little direct collaboration between artisan and engineers. Indeed few managers truly understand the risk models used in assessing portfolio risk or in the optimization process. New Frontier is an exception to the rule. New Frontier is a global software provider and consultant of state-of-the-art investment technology that also manages money solely with its technology. A direct coupling of asset management with investment technology provides a virtuous circle of software improvements based on research. Technology is refined with full knowledge of how it is used. An integrated engineer-artisan investment process may often provide a more reliable framework for effective asset management.

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Hybrid Strategic Asset Allocation

New Frontier's global strategic model portfolios are designed for meeting an investor's long-term investment objectives. They are neither passive nor tactical. Directional strategies can certainly produce enhanced results in a given investment period but are unlikely to be sustainable over the long time horizons required for long-term investing. Passive strategies that rely solely on capital market structure ignore changes in markets, investment vehicles, technology, and regulation. New Frontier's portfolios are a hybrid of active but non-directional investing anchored to capital market structure but overlaid with current information implemented with state-of-the-art investment technology.

Research News

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 available on our website: www.newfrontieradvisors.com. We will be presenting the paper "Deconstructing Black-Litterman: How to Get the Portfolio You Already Knew You Wanted," by Richard Michaud, David Esch, and Robert Michaud, accepted for publication in the *Journal Of Investment Management*, at the CFA UK institute in London April 9, 2013 and at QWAFEFW New York February 26, 2013. An [Executive Summary](#) of the paper is available at our website. Publication is currently scheduled for the 1st quarter of 2013.

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