NEW FRONTIER

# Market Perspectives: 3rd Quarter 2012

Enhanced Return ▪ Effective Diversification ▪ Managed Risk


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## Market Respite

In a period of looming macroeconomic risks and great investor uncertainty the quarter resulted in solid gains in most global equity markets. The Dow was up 4.3%, the S&P 500 5.8% and the NASDAQ 6.2% for the quarter. Year-to-date the Dow was up 10%, the S&P 14.5% and the NASDAQ 19.6%. The news internationally was encouraging though mixed with European indices up 8% for the quarter and 11.8% for the year while Pacific indices were up 2% for the quarter and 7.4% for the year. On the other hand bond indices performed largely within expectations with the Barclays Capital Aggregate Bond Index up 1.6% for the quarter and 4% for the year. The VIX volatility index reflected surprisingly moderate risk levels and is currently at 15, near its low for the quarter. The dollar declined slightly relative to the euro and yen while oil prices rose 7%. Nearly all of New Frontier's ETFs were in positive territory for the quarter and the year.

## Perspectives

The continuing concerns of the eurozone crisis and sluggish growth in the American economy weighed heavily on investors' minds. Central banks were key factors during the quarter that helped revive investor sentiment and led to gains in many markets.

In late July, the president of the European Central Bank (ECB), Mario Draghi, announced that he would do "whatever it takes" to save the euro. "The euro is irreversible" he said. He agreed to purchase struggling countries' debt without limit. His proposal included eurozone-wide direct bank supervision and regulation, in effect a eurozone banking union. Bailout funds would, of course, come with conditions.

Draghi's initiatives represented what many consider a last resort to save the euro. His proposals provide most of the tools necessary for managing the debt crisis. But eurozone angst was renewed when German, Finnish, and Dutch finance ministers voiced reservations to the Draghi plan. Details of the agreement still need to be worked out and voted on. Though still promising, no political consensus has definitively emerged.

In the meantime the eurozone is likely in recession. Social unrest is widespread particularly in Spain and Greece. Unemployment is over 11% eurozone wide. Significant capital flight is occurring. Billions of euros are being pulled from banks in Spain, Portugal, Ireland, and Greece creating a two-tiered banking system that is blocking economic recovery and blunting ECB policy.

Domestically, the Fed announced a third round of quantitative easing in order to address anemic U.S. growth. The plan focuses on lowering unemployment by stimulating mortgage lending. The announcement was greeted as an acknowledgement of persistent slow economic growth.

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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**.

The Fed's plan is unique in that a $40B plan to purchase mortgage backed securities each month has no timetable for ending. Unlimited bond purchasing coupled with a forecast of low interest rates for some time to come provides ongoing support for further economic growth.

Domestic economic activity was not all bad news. The Institute for Supply Management (ISM) reported that manufacturing expanded in September. This unexpected result came after three months of contraction and eased concern that the American economy will slow further. In addition, sales of existing homes in the U.S. rose in August by 7.8%, the highest level since May 2010. The U.S. housing recovery seems to be for real. Indeed, some parts of the country are experiencing a real estate boom.

## Look Ahead

How did equity markets end up positive for the quarter in spite of pervasive investor skepticism? Markets hate uncertainty. The pronouncements by the ECB President and the Fed are the obvious factors. But how much further can stocks rally? Are the gains sustainable?

The eurozone debt crisis continues to fester and remains unresolved. In particular the troubles in Greece and Spain are reaching a critical stage with 25% unemployment, street riots, and unsustainable high debt financing levels.

The eurozone crisis is the function of two competing views of its genesis and resolution. Northern Europeans see no end to bailouts without commitments to sound fiscal management and the end of public profligacy. On the other hand southern Europeans view austerity demands in a severe downturn as counter-productive in stimulating economic growth while creating needless human suffering. Each group is suspicious of the motives of the other. The credit excesses of the southern economies have often been encouraged and have largely benefited the northern economies. In the meantime high unemployment, declining economic growth, business destruction, social unrest, and the flight of human capital pose a likely grim economic reality for indebted countries for many years to come.

A euro exit is the natural solution for the indebted countries. From a purely economic perspective it is hard to understand why Greece has not already exited the euro. But the eurozone has a stake in not allowing euro exits. The financial disruption of even one country exiting the euro may augur the unraveling of the currency for all. The Draghi plan seems to offer a serious hope for resolution with the fewest negative implications. There is reason to believe that some consensus will emerge simply because no alternative is acceptable.

In the U.S., political uncertainty relative to the November presidential and congressional elections and ongoing political dysfunction and gridlock in Washington threaten prospects for the American economy. In particular, the

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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.

end-of-the year fiscal cliff is the focus of many investor concerns. The elections may have a significant impact on fiscal management and tax policy.

The global economy continues to experience headwinds. China is experiencing a political transition and economic slowdown. The rise of nationalistic fervor in China is raising alarm bells for its Asian neighbors, particular in Japan. The Middle East continues to ferment as the Arabian spring evolves into day-to-day management issues and requires addressing the widely diverse expectations of its citizens.

For the future, the Fed stands ready to promote economic growth with all the tools at its disposal. The open ended mortgage backed buying program should encourage a rebound in housing, construction, and consumer spending. The coordination of the Fed with other central banks holding interest rates low will help in supporting global equity values.

Recent positive developments for the U.S. investor include lowered costs for Exchange Traded Fund (ETF) investing. Vanguard and Schwab recently announced reductions in management fees. BlackRock is also expected to announce fee reductions soon. The success of Apple Computer's iPhone 5 cellphone highlights the importance of innovation for promoting economic growth in equity markets. Innovation remains the fundamental source of economic growth in capital markets.

In a major development, NFA has developed software for implementing the multi-patented Michaud-Esch algorithm for overnight portfolio monitoring for all portfolios we manage. The new procedure avoids calendar and other ad hoc methods in widespread use in contemporary asset management. Consequently, each Genworth portfolio we manage is now monitored for optimality on a continuing overnight basis with state-of-the-art asset management technology.

Finally, for investors who have considered so-called "risk parity" strategies it is worth noting that such portfolios imply much larger allocations than traditional strategic in fixed income and other non-equity asset classes. There are two versions of the procedure: leveraged and non-leveraged. New Frontier does not recommend leveraged strategies for long-term strategic investors. In the non-leveraged case the equivalent risk parity strategy for a New Frontier GSAA 60/40 asset allocation is roughly 20/80. We note that risk profile one and two of our GSAA model portfolios are close replicates of non-leveraged risk parity strategies that have the added benefit of our patented optimization and asset management technologies for equivalent stock/bond ratios.

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## 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 has been accepted for publication in the *Journal Of Investment Management*. An Executive Summary of the paper is available at our website. We also recently completed the research paper "Morningstar vs. Michaud Optimization," by Richard Michaud and David Esch, which is also available on our website.

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