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Rear View Mirrors

It was another positive quarter for U.S. equity investors. The Dow was up 6.4%, the S&P 5.9% and the NASDAQ 4.8%. The market's resilience in the face of the Fukushima earthquake, Middle East rebellions, and euro uncertainties was remarkable. The U.S. economy continued to demonstrate significant signs of recovery with 216,000 new jobs in March and a 1% drop in the unemployment rate since November. International equities were more of a mixed bag. While European markets were up 6.5% in dollar terms, Asian indices were down 2% as a result of the troubles in Japan. Bond market indices were mixed, with treasuries modestly down and diversified indices flat or up slightly. Oil prices were up over 16% while the dollar fell 6.4% relative to the euro but up 1.3% relative to the yen, with the VIX at 18%.

New Frontier's domestic equity and fixed income ETF investments continued to perform well. NFA's higher equity global risk profile portfolios underperformed relative to the S&P index primarily due to Japanese returns. However, our risk-management process worked as intended, with systematic risk levels well correlated with performance.

Perspectives

The backwash of the financial meltdown has made it fashionable for pundits to declare that diversification is dead. As a practical matter, in the presence of severe unforecastable geopolitical events, all the correlations may go to one, negating risk reduction diversification benefits. The severity of the meltdown led to proposals for a number of rear view mirror strategies. These include risk parity, minimum variance, leveraged low risk (very dangerous), tail risk, momentum, and many others. What all have in common is a heuristic for reducing equity risk.

But investors should be skeptical. Many media pundits, strategists, and analysts have been wrong for over two years in a row. The widely predicted new normal is nowhere to be seen. Moreover, low asset risk portfolios are not risk free. During a period of zero interest rates, the S&P was up nearly 100% and the Russell 2000 small cap index up nearly 150% since March 2009 lows. Opportunity costs can be very painful; whipsawed investors may require many years to recoup losses. The fundamental law of risk management is simple to state: Effective global diversification is the only truly reliable risk management tool available to investors.

Dismissing Markowitz mean-variance (MV) asset allocation because some strategies did not work well over a specific period is ill advised. MV optimization is a Nobel Prize winning invention that is at the heart of all modern finance and asset management. However, it is certainly the case

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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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that some managers may be less adept at managing technology than others. More importantly, NFA's research has demonstrated that classical MV asset allocation is ineffective in practice. The problem is not the concept of diversification but practical implementation. NFA's patented Resampled Efficient Frontier™ (REF) optimization is provably effective at creating well diversified portfolios.

One reliable lesson that can be drawn from the meltdown is that static academic asset allocation is inadvisable even for long-term investors. NFA has pioneered a middle ground that is neither static nor based on directional forecasts. We use Bayesian methods and other advanced statistical techniques to rigorously blend current and relevant historical information and financial principles of asset management in the investment process.

The European sovereign debt crisis continues to evolve. The disparities between German bund yields and other markets indicate serious ongoing unresolved political issues for the European Union. Closer to home spiking commodity prices, political agendas, housing crisis, and unsustainable unemployment levels may all impact the course of the recovery. In addition, many state and local governments are in major budget crises.

Look Ahead

The Fed's stimulus programs are the most important game in town. The Fed has guided a significant recovery in economic productivity and capital values. End of March job growth contrasts sharply with the 700,000 jobs lost in the first month of the Obama administration. While serious problems remain, a wide consensus of working economists agrees that the economy is currently on the right track. Some have described the U.S. economy as being in a Hyman Minsky virtuous cycle.

The clouds on the horizon are mostly political, not economic. While all economists agree that the budget deficit must be funded, the question is not whether but when, how aggressively, and over what time period. Spending cuts that are too large and too soon are likely to throttle the recovery, plunge the economy into recession, and increase unemployment. Alec Phillips from Goldman Sachs notes that many proposed federal spending cuts reflect the most important near-term risk for the economy. Mark Zandy of Moody's Analytics reports that the spending cuts proposed by House Republicans would be taking an unnecessary chance with the recovery. Both are extremely concerned with the economic consequences of a federal shutdown from unwillingness to raise the debt ceiling. Joseph Stiglitz, the Nobel Prize winning economist, commenting on the Bowles-Simpson deficit reduction report, states that their recommendations would constitute a near-suicide pact for the American economy.

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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.

Research News and Announcements

New Frontier is the proud sponsor of the Harry M. Markowitz award for papers of distinction published each year in the *Journal Of Investment Management*. The awards were presented for the first time at the 2011 spring conference in San Diego with Drs. Markowitz, Scholes, and Sharpe in attendance. The awards were selected by a panel of four Nobelists in Finance. First Prize was awarded to Andrew Lo and Mark Mueller of MIT for their paper: "Warning: Physics Envy May Be Bad for Your Financial Health". We are also proud to note that one of two Prizes for Distinction was awarded to David Esch of NFA for his paper: "Non-Normality Facts and Fallacies".

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It is only fair to observe that political calculation is far from unique to the U.S. The European Stability Mechanism slated to be funded by European states has many unresolved issues and various recent resolutions made by the European Council is unlikely to be enough to carry us through the current crisis. China's yuan policies and Japan's pre-disaster monetary policies are all politically motivated. It is also worth noting that violent demonstrations against too harsh austerity programs that have taken place in other countries can happen here and may have serious undesirable economic and investment consequences.

It is legitimate, however, to be concerned when and how the era of low interest rates will end. Informed commentary indicates that QE2 is likely to end in June and that the Fed will take a largely neutral stance going forward. Indeed, the Fed has already begun dismantling some of the credit supports it had been using. At a minimum, short- and mid-maturity government yields will inevitably rise, and bond prices fall, in the not indefinite future. Setting short-term interest rates is far from the only tool at the Fed's disposal. How disruptive such a period may be for investing depends on your belief of the efficiency of global capital markets.

There are many possible scenarios. Draining liquidity from credit markets will affect longer-term and non-government bonds, equities, the dollar, and purchasing power in many unpredictable ways depending on the state of the economy and global capital markets. Possible give backs may be more nominal than real. A change in equity prices may not result in changes in purchasing power. An increase in investor risk aversion may cause a flight to quality and rising bond prices if all other things stay the same. But an efficient market perspective does not imply that investors should be unconcerned with weightings in shorter term treasuries. NFA's bond portfolios are very highly diversified and include many kinds of U.S. as well as non-U.S. bond and non-equity ETFs.

Recent experience confirms the fundamental importance of effective risk-appropriate globally diversified portfolios for meeting core investment objectives in the presence of unforecastable geopolitical events. An effectively diversified ETF portfolio can be a valuable component of a well-defined investment program for many investors. Innovation remains the ultimate source of economic growth in global capital markets.

The future will require more sophisticated technology to meet expanding investor needs. NFA has recently developed new methods (U.S. patent pending) for implementing optimized derivative overlay asset allocation strategies using our patented optimization technologies. These and other techniques may enable a wider more useful palette of effective investment strategies for 21st century asset management.

April 6, 2011