Market Perspectives: 4th Quarter 2010

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

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Strategic Redux

Conventional market forecasts were wrong for the second year in a row. The widely predicted and feared "new normal" of lower than historical returns was nowhere to be seen. Fear encouraged by media hype and many academics, strategists, pundits, and political analysts, led many investors to flee diversified equities and balanced funds and pour into bonds and low risk alternatives for the last two years. During an era of zero interest rates, diversified equity indices and core global strategies were solid investments. The Dow was up 7% for the quarter and 11% for the year, the S&P 11% and 15%, and the NASDAQ 12% and 17%. This followed an even more positive 2009 when the Dow was up 19%, the S&P 26%, and the NASDAQ 44%. Since March 2009 lows, the Dow is up 86%. Patient thoughtful risk appetites were well rewarded. Relatively risky small cap and growth stock indices had a great quarter and year. Even European stocks beset by euro skepticism and sovereign default risk managed to post positive though modest gains. The quarter also saw the inevitable end of the bond rally. While the Lehman Aggregate Bond Index was down 1% in the quarter, it was still up 6.5% for the year.

Nearly all ETFs used by New Frontier posted positive returns for the year. More importantly, for the quarter, the year, and the more than six years since inception, NFA's six risk profiles were well correlated with increasing positive returns, performing perfectly consistently with their core strategic mandate of risk-targeted-appropriate enhanced return funds. Our funds are not whipsawed by ephemeral factors or media hype. The Michaud Resampled Efficient Frontier™ optimizer is the world's only provably effective investment technology for creating enhanced diversified portfolios. Enabled with effective advanced technology, and implemented with institutional quality strategies and principles, NFA's strategies worked as intended. Predictions of the demise of core risk-target investing for appropriately meeting long-term investment objectives seem highly premature.

Perspectives

"Stocks have reached what looks like a permanently high plateau." – Irving Fisher, October 1929. Fisher's error was not a display of incompetence but of the complacency that inevitably evolves from sustained periods of positive market performance and economic growth. In every era, including ours, experts have announced that capital market volatility has been tamed and economic cycles moderated only to be surprised by sharp unanticipated declines.

A severe downturn typically exposes many comfortable but flawed truths. The efficient market hypothesis, market equilibrium theories, academic empiricism, and the development of financial innovations have

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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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often been misunderstood as justifying a laissez-faire mentality and overconfidence in self-healing markets. It is difficult to argue against profits and large bonuses spurred by over-leverage and speculation until the bubble bursts. Unfortunately, the consequences of economic misunderstandings and misinformation often exact severe human suffering, as they have recently.

The boom and bust of recent history has led to serious questioning of many precepts from academic studies and theories. Note Allen Greenspan's admission of likely error of over reliance on market mechanisms during testimony on the credit crisis in congressional hearings. An extensive analysis of the fundamental causes of the Great Recession is beyond the scope of this report. See Quiggin's (2010 Princeton) *Zombie Economics* for further discussion and up-to-date analysis.

A revisionist mentality has taken hold of much of the professional community. The backlash is long overdue on the over-reliance and misunderstandings of long-term academic studies as a basis for asset management. At the same time, many proposals for avoiding static investment strategies have their own serious limitations. While effective directional active management may be desirable, there is little evidence of the availability of sustainable risk-adjusted reliable methods. In contrast, NFA's strategic investment process is neither static nor directional; current information is used in the context of advanced statistical estimation technology to inform the fund construction process relative to the evolving structure of contemporary capital markets and the economic environment.

The mid-term elections removed a good deal of uncertainty about tax and government stimulus policies for the next two years. The new congress will be less government intervention oriented, but few changes in current economic policy are likely to result for the remaining term of the Obama administration. There continue to be small but persistent positive signs of a sustainable though fragile U.S. economic recovery. Even the recent and inevitable rise of short and medium term interest rates may be as related to the demands of a growing economy as it is of the necessary readjustment from a low interest rate Federal Reserve policy.

Significant risks continue to loom over the global economy. One of the most important is the unresolved European sovereign debt crisis and its potential impact. Troubling disparities between the German bund yields and other euro markets exist. Euro problems may continue to dog the European recovery. Other risks include China's ongoing currency disputes, military incidents with Japan, recent rate increases, and military skirmishes between South and North Korea. While inflation risk within the U.S. seems limited or at least short-term, commodity prices have soared. In addition, many state and local governments are in major budget crises.

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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 will be presented for the first time at the 2011 spring conference in San Diego with Dr. Markowitz attending.

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Look Ahead

The key questions for investors is whether the U.S. and the global economic recovery will continue and whether it is now time for sidelined investors to return to investing in risky assets. How much return can be left of the nearly two-year bull market as reflected in an 86% rise in the S&P since early March 2009? Can improving market sentiment and consensus for a sustained though fragile economic recovery point to a limited opportunity? Some positive signs include a normal short and long-term risk-return relationship for NFA's six risk profile funds that is consistent with normal functioning capital markets. In addition, current market indices are still far from the 2007 peaks before the overleveraged speculative bubble began to unravel.

One positive interpretation of the current state of capital markets is a "return to normalcy" hypothesis. The two year rise in the market may simply reflect the value of the real economy if it had not been interrupted by the financial credit meltdown. Current index levels are similar to past levels when excessive unregulated leveraging may have had limited impact on capital market levels. If the hypothesis is correct, investors should not worry about the level of return left in capital markets. Future returns should reflect the real economy going forward independent of prior excesses of over leveraged speculative activity.

While a "return to normalcy" hypothesis may provide some comfort for sidelined investors, it is not without criticism or risk. Until the U.S. can return to a more normal level of unemployment and housing activity, it is hard to be sanguine for a smoothly functioning economy and markets realistically reflecting real economic activity.

For investors, it is worth noting that recent experience has provided much confirming evidence of the importance of a risk-appropriate strategic core portfolio for meeting long-term objectives. A risk-targeted core strategic portfolio with broad based ETFs and effective investment technology 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.

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