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A Fragile Recovery

The year 2009 was extraordinary in modern finance. The U.S. economy began to slowly emerge from the worst economic recession since the 1930s. The Dow recovered from a 25% decline through early March to rise nearly 20% for the year, its best performance since 2003, while reaching levels last seen in October 2008. The tech heavy Nasdaq index had a very good year rising 45% while many European equity markets had similar or better performance than the Dow and many Asian markets were stellar performers. However, many investors are still hurting. The Dow is still 25% below its highs in October 2007.

The last quarter of 2009 found investors inching up a wall of worry. Concerns about deficit spending, Fed and fiscal stimulus policies, inflation, the dollar, and the exit strategy led many strategists, traders, business media and other seers to predict market declines during much of the last half of 2009. While the Dow rose 8% during the quarter, each new sign of economic recovery was greeted with skepticism. Positive surprises included: 11,000 job losses in November as compared to 700,000 in the first month of the Obama administration; commercial banks reporting large profits and bonuses while returning TARP funds; GDP growing over 2% annualized in the third quarter; housing starts and resales up; inventories down; productivity up; and consumers saving more while using less credit. Commodity markets showed signs of stability, and the VIX reflected more normal long-term values. A relatively stable financial climate saw firms adjusting to a more normal economic reality. Amusingly, even business channel hosts noted ironically how unreliable experts and business journals were during 2009.

While valuable for the year, the quarter was a challenging one for global diversification. Many European and Asian diversified indices were relatively poor performers on a dollar basis relative to domestic. Long-term treasuries also underperformed, reflecting concerns on the direction of short-term rates. An appetite for risky U.S. securities emerged.

Perspectives

It is useful to look back to understand where we are and where we are likely to be going. In the fall of 2008, global credit markets were near collapse and a depression seemed imminent. Credit market dysfunction can spawn a deflationary cycle that can lead to massive destruction of real economic value and take many years to recover while causing devastating human suffering.

But we have been here before. Human history is replete with financial crises and their consequences. As in the 1930s, and in many other cases,

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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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the lead-up to the financial crisis was characterized by wide use of excessive leverage, so-called financial innovations, investment fraud, speculative fever, and lax regulation. The authors of *This Time is Different* (Reinhart and Rogoff, 2009) demonstrate how similar financial crises have been over the course of 800 years of human history. The classic *Extraordinary Popular Delusions and the Madness of Crowds* (Mackay, 1841) reads hauntingly familiar. These authors remind us how difficult it is to understand a bubble while in it or to stem the process before the damage is done. Before the bubble bursts, with so many making so much money, political will is non-existent until it is too late.

The consequences of financial crises are typically dire and long lasting. But history does not have to repeat itself. Many serious consequences of a financial crisis can be limited if guided by a modern understanding of macroeconomics coordinated with the political will to implement unfamiliar or unpopular measures. Many of the great economists of the 20th century, including notably Keynes and Samuelson, were focused on understanding and managing the consequences of the 30s depression. The Fed's Ben Bernanke, *Time's* Person of the Year, has studiously avoided many of the errors of the 30s, including a passive Fed and a simplistic view of deficit spending, while guiding and promoting the need to stimulate economic activity.

A main factor in the disconnect between traditional perceptions and this year's market performance is a lack of appreciation of the effectiveness of the monetary and fiscal tools and policies that have been implemented. Initiatives for credit market pump priming and stimulating economic activity include near-zero lending rates, paying interest on required reserves, extending the term on overnight loans, purchasing mortgage-backed securities, agreements with central banks for currency swaps and coordination of policies, promotion of TALF and TARP programs, and guiding the stimulus package. While many initiatives are works in progress, together they reflect a level of innovation and pragmatism unheard of in financial history. Recently the Congressional Oversight Panel credited TARP as an important part of a broad government strategy that has stabilized the U.S. financial system and avoided an acute economic crisis.

Look Ahead

The economy remains in the recovery room and requires continued informed management. Unemployment will remain near 10% for much of 2010. Many millions of jobs have to be created to reach a more politically acceptable rate. At some point the economy will begin to grow and the Fed policy on short term interest rates will end. Even if inflation is managed well, various asset bubbles or declines in the value of the dollar are likely. Small banks need to resume lending. The peg of the dollar to the renminbi, while possibly benefiting both countries short-term, is not sustainable or beneficial long

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term. Regulatory reform is required to avoid a repeat of the crisis.

Most importantly, political will is required to avoid recidivism to the self-defeating policies that characterized the 30s. Mackay's narrative on financial crises reminds us of the delusions of many required to support the bubble, the subsequent recriminations when the bubble collapses, and the continued delusions of those who were its proponents and don't want to admit error. Mackay describes extended periods of extreme social and political unrest, jailings, and murders. A toxic partisan political climate will add much to the uncertainties of the fragile recovery settling over the global economy.

Stock market commentators have called the 2000s a lost decade to stock investors and have questioned the benefits of core or static long-term asset allocation. It is true that an investment in the S&P index would have lost money over the last ten years. But much of the critique of core investing is based on an improper definition in practice. A core investment should be globally diversified, risk-appropriate, and effectively rebalanced and managed relative to objectives. Consider a more realistic scenario of investing in a 50/50 global equity/bond fund, annually rebalanced, with regular contributions. Leiber (*New York Times*, 1/1/10) reports on a Vanguard study that showed that such an investment would have returned over 10% in this ten-year period inflation adjusted. It is also worth noting that the start of the decade was roughly the top of a prior bubble. Long-term core investing properly managed remains as relevant today as it has ever been.

Optimized asset allocation itself has also come under criticism. Critiques of the Markowitz mean-variance framework and its extensions have been used to excuse poor performance. But suggestions of alternatives are often based on a limited understanding of modern statistics. Esch's "Non-Normality Facts and Fallacies" (*Journal of Investment Management*, 1st Quarter, 2010) (available by the end of January at www.newfrontieradvisors.com), provides a comprehensive analysis of many of the fallacies associated with critiques of optimized asset allocation current in the investment community.

For the future, the many current economic and capital market uncertainties provide continuing incentive for globally diversified risk-appropriate investments. It is worth noting that the VIX is now at a level more consistent with rationales for long-term investing. Better regulated capital markets and stable growth oriented monetary and fiscal policies, where excessive leverage is limited, is a positive scenario for core investors. Effectively diversified global asset allocations remain a likely component of a well-defined investment program for many investors.

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