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Market Perspectives: 4th Quarter 2008

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

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The Wages of Unrealistic Expectations

Few periods in financial history have seen more severe quarterly declines in security values than the most recent quarter. Misaligned incentives, short-term corporate policies, unconscionable leverage, fraudulent lending, and regulatory failures combined to victimize investors large and small this year and led to a financial and economic crisis of historical proportions. The bursting of the housing bubble resulted in severe losses in credit derivative strategies based on securitized packages of mortgages (CMOs) that cascaded into defaults and failures of major banks, insurance companies and large corporations. Fire-sale deleveraging during the quarter resulted in many closures of hedge funds, bankruptcies, and government sponsored takeovers.

The presence of trillions of dollars of unregulated credit default swaps (CDS) was the source of great instability in global credit markets. Unlike traditional insurance, CMOs and CDS represented highly correlated risks and a positive feedback system that in declining markets resulted in death spiraling defaults and failures. The lack of transparency and the impact of multiple layers of leverage continue to negatively impact credit practices and the functioning of markets. Future regulatory reforms are likely to require a clearinghouse for credit derivative markets.

The VIX index, currently roughly 40%, has been as high as 80% during the quarter and remains at a level reflective of depression era market volatility. It is hardly coincidental that the worse investing quarter of the year occurred in the remaining months of a lame duck administration. The Bush administration's capital injection and troubled asset relief program (TARP) can take some credit in returning credit markets to a more normal level of functioning at the short end of the term structure. The Federal Reserve has set short-term interest rates to essentially zero trying to jump start the economy. Yet the economic outlook is bleak for the new year. Current volatility levels are very destructive to many financial planning objectives.

Given the turmoil, it is little wonder that the long-term average positive relationship between risk and return has reversed. The systemic risks that have affected capital markets in 2008 are not indicative of normal functioning capital markets. However, it is worth noting that long-term positive risk/return relationships exist precisely because risk may lead to less return in some periods. Experienced investors such as John Bogle counsel that a ten year outlook may be important for many investment decisions.

If there is a single cause of the financial crisis of 2008, it has been investors' unrealistic expectations. Too often, demand for leveraged strategies was promoted with promises of extraordinary returns and little risk. Institutional trustees were often impatient with single digit returns and conventional strategies. Few segments of the investment community were not complicit. Professional associations, conference promoters, institutional consultants, investment banking strategists, and celebrity academics often hyped highly leveraged, double digit

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About New Frontier

New Frontier is a Boston-based institutional research and investment advisory firm with an extensive background in quantitative research, consulting, and management. 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 cutting-edge practical economic theory, New Frontier's services help institutional investors, across the globe, to select and maintain more effective 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.

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investment strategies. As in the Madoff affair, lack of transparency was often promoted as mystique, or membership in a select club, instead of as a collapse of common sense or a dereliction of fiduciary responsibility.

In recent times, highly levered investment strategies often prospered in a market when the VIX at 10% indicated well below normal historical volatilities. With higher capital market volatility, like desert flowers blooming in an unusual rainy season, many faltered in more normal or harsher environments. The laws of economics and finance grind inexorably. What often seemed too good to be persistent wasn't.

What can investors do for the future? Investors need to have more realistic investment expectations and a willingness to go back to basics. The time-tested fundamental principles of long-term investing include transparency, effective diversification, low cost quality investments, and proper risk management.

Our investment strategies are firmly based on implementation of fundamental investing principles. Our patented optimization process is the only provably effective optimizer today. It is also transparent and stress-tested in peer reviewed journals by world authorities. In addition, we employ lower cost, tax efficient, transparent ETFs. A spectrum of stock/bond ratio risk-controlled portfolios provides investors with relevant options for proper risk management given objectives.

Finally, it is worth repeating our thoughts on risk management from the prior quarter's commentary. In a prolonged financial storm, it may be wise to reduce equity exposure by moving to a lower risk profile if the risk level in capital markets is perceived to have shifted from normal levels for some time to come. On the other hand, the rescue plans proposed and in place for many countries worldwide and a new administration taking office soon may augur for more normal functioning of capital markets in the not distant future. For the long term, real economic growth, including innovation, remains the fundamental source of financial value.

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