NEW FRONTIER

# Market Perspectives: 1st Quarter 2017

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

Dr. Richard O. Michaud

President and CEO

New Frontier

Dr. Michaud earned a Ph.D. in Mathematics from Boston University and has taught investment management at Columbia University. He is the co-holder of four U.S. patents and is the author of *Efficient Asset Management* and many professional and academic articles.

## March Madness

### Markets

The first quarter of 2017 was a profitable one for many strategic domestic and global equity investors. All major domestic large cap indices are up for the year: S&P 500 is 5.53%, Dow 4.56%, and NASDAQ 9.82%. On the other hand, domestic small cap underperformed with the Russell 2000 gaining 2.12%. Diversified global equity performed well: ACWI gained 6.91% and the ACWI ex-US gained 7.86%. International developed markets were mixed with the STOXX 50 returning a competitive 6.39% but the Nikkei 225 decreased by 1.07%. Emerging market indices were stellar performers with the MSCI EM IMI index gaining 11.65%. Once again, there is a significant difference in off-shore and on-shore performance in China. The SSE Composite is up 3.83% while the Hang Seng is up 9.60%.

Bonds and equity alternatives posted mixed results. The US AGG is up 0.82%, while the Dow Jones US Select REIT index posted a negative 1.18% return. The US Dollar declined 1.55% against the Pound, 4.81% against the Japanese Yen, and 1.31% relative to the Euro. On the other hand, gold increased by 8.31%. Oil held steady in January and February, but experienced a decline in March, finally settling at $50.60 per barrel at the end of the quarter. VIX is at 12.37, remaining below historical volatility levels. The 10-year T-Bill is at 2.40%. Though it was a good quarter for global markets, it was an even better quarter for New Frontier portfolios. Anticipated returns are in line with risk exposure, with the most conservative portfolios expected to return over 2% for the quarter and the all equity portfolio up approximately 7%. Notably, nearly all of New Frontier portfolios are expected to perform ahead of their respective benchmarks. (These returns are calculated based on publicly available ETF prices; for details about this calculation, please see the Disclosures section at the end of this report. More details about portfolio performance are available at www.frontieradvisor.com.)

### Perspectives

March 2017 marked the eighth anniversary of the second longest bull market in modern capital market history. The quarter itself was no less stellar. March saw the Dow break through 21,000 in just 24 days after breaking 20,000. Yet the frenetic Trump bounce that followed the 2016 presidential election finds investors at the end of the quarter with much uncertainty about the future.

The difficulty for understanding the current state of global capital markets is how to parse eight years of grinding, largely globally coordinated, central bank monetary macroeconomic policy relative to the release of political stalemate sentiment resulting from the Brexit vote and the 2017 Presidential election. Both the presidential election and Brexit are watershed moments in geopolitics. Political anger that had

*continued on page 2*

## 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.

been building up for years from both left and right perspectives was climactically released and, in many ways, therapeutic. Domestic politics in America were in an eight year stalemate. With the major exception of the flawed Affordable Care Act, the Obama administration was literally confined to policy by executive orders. The sentiment is that, with political stalemate eliminated, there are policies that all can agree with, though in varying degrees. These include the need for infrastructure spending, tax reform, and revised regulations. Britain was better off knowing that the country definitively wanted to leave the EU, and the U.S. that deadlocked politics were at an end, whether or not the results were likely long-term positive.

But many unexpected things happened on the way to U.S. political nirvana. For the last eight years the Republican Party governed as the party of no. But now it must govern. Governing means developing and implementing proposals that meet realistic needs and objectives. The transition has been traumatic. Both the Republican dominated congress and executive branch have stumbled badly. The Republican proposal to repeal and replace the Affordable Care Act went down to crushing defeat. The President's tenure during the quarter is likely to be remembered as much for tweets as anything else. On March 20th, the FBI Director, John Comey, told congress that there is an ongoing investigation into foreign meddling with the American Presidential election, including possible participation by members of the Trump campaign. There is a great deal of political uncertainty as we look beyond the first quarter of 2017.

In spite of almost daily political turbulence, the state of the U.S. economy is very encouraging. By many measures, the Fed has met its objectives. After eight grindingly difficult years, the economy has healed. The Federal Reserve in March voted to increase short-term rates. Wage growth has returned, unemployment is well below 5%, and inflation is close to 2% target. The Fed is now turning its attention to reducing its $4.5 trillion balance sheet. The plan is to gradually loosen the reins without disrupting the markets while continuing to monitor the economy.

A recovery appears to have taken hold in the 19 member eurozone. The ECB has become increasingly confident that their monetary policies are effective and that goals are on track. Accelerating growth and looser credit conditions have brought a steady improvement. The current critical eurozone uncertainty is political with key elections in France and Germany. But the recent Dutch elections reflected a return to mainstream parties indicating that there may not be major political upheavals near term. This is comforting news since the eurozone is a far more complex economic-political entity than the U.S. Stubbornly high unemployment peaked at 12.1% in 2013 and is still at a dismal 9.5%. But the ECB has pared down its monthly purchases of European debt from 80 to 60 billion euros in April. Of course, the impact on the bond market has been significant with negative yields not uncommon with little further upside and plenty of room downside. While often an unreliable indicator of the health of an economy, European stocks were nicely positive in the quarter.

*continued on page 3*

## New Frontier Portfolios

New Frontier develops and manages a broad range of ETF asset allocation portfolios for advisors and their clients, and currently oversees nearly $2 billion in global ETF asset allocation portfolios.

China is often considered an emerging market even though it is the second largest global economy. While quarterly equity returns were healthy, there are many risks for unwary investors. China's central bank has to carefully manage encouraging growth while bringing down unsustainable levels of debt and for managing external and internal political risks. The Peoples Bank of China (PBOC) has tightened credit to limit financial risks to prevent excessive borrowing while limiting capital flight. But this has pushed up borrowing costs making it more expensive to borrow. The level of debt to GDP is estimated to be nearly 300%. A campaign for rooting out corruption internally and dealing with a protectionist American president who claims China's currency is being manipulated adds further levels of complexity to managing a vast though wealthy economy. Investors are wise to be wary of the endemic risks that need to be managed.

Weaker currency and global demand have been positive influences for the Japanese economy. However, protectionist sentiment and tightening monetary policies in the U.S., slower growth in China, and weak domestic spending remain important head winds for Japanese markets. Economic growth projections are in the 1% range for 2017 and 2018.

## Look Ahead

From a domestic investor perspective, nearly continuous political upheavals are unhelpful for sustainable economic growth. Business managers often need to plan two or more years in advance based on long-term economic and political assumptions. Can America reach a politically stable state near term? For a number of reasons, the next three to six months are likely to be as turbulent as the last three. A bitterly divided and suspicious electorate is unconducive to economic growth. The results of the congressional and intelligence agency investigations into the 2016 presidential election, likely three to six months from now, has the potential for explosive turmoil. It seems a safe bet there will be little let up in name calling and charges of malfeasance. The defeat of the Republican health care bill has diminished optimism of whether Congress can deliver Trump pro-growth tax reform and infrastructure spending policies. Trump protectionist policies have been widely critiqued as likely damaging American high tech and academic dominance while increasing inflation. Harsh immigration enforcement could bitterly divide the country. The most important good news is that the outlook for the basic health of the American economy remains robust near term.

A military confrontation with Russia either in Eastern Europe or in Iraq still seems remote. China is likely to muddle through though at great cost to many segments of the Chinese economy. Japan remains mired in slow growth for the foreseeable future. Other geopolitical hotspots include the Middle East, North Korea, and China Sea.

*continued on page 4*

## New Frontier Portfolios

New Frontier develops and manages a broad range of ETF asset allocation portfolios for advisors and their clients, and currently oversees nearly $2 billion in global ETF asset allocation portfolios.

While the consequences of Brexit reflect serious risks for the British economy, it is less important on a global basis. The level of discontent with immigration policy that generated the populist political movement was not isolated to Britain. On the other hand, the ECB seems to be winning the economic battle, though at a high cost. There does not seem to be significant sentiment to break-up the eurozone or the euro.

# Efficient Long-Term Investing

Our January commentary (1/3/17) discussed some critiques of index-fund ETFs topical in the investment community. The argument was that ETFs, because they trade like stocks, tend to encourage investors to trade actively as opposed to traditional mutual fund investing. But it is always true that anything can be misused however otherwise beneficial. In our view, ETFs are the modern way to invest. ETFs are roughly half as expensive, more transparent, and more tax efficient than comparable mutual funds. They are also easier to manage when adding funds or requiring redemptions. ETFs are popular even with many long-term institutional managers.

ETFs tend to raise the issue of passive vs active investment. This is because many ETFs are rule-based index fund products. Passive investing has a negative connotation for many investors. Price discovery in a capital market can't exist if all investors are passive. Moreover, any truly mechanical or rule-based strategy can be gamed by high frequency trading (HFT) managers. HFT algorithms continuously monitor trading patterns in global capital markets at high computational speed. A consistent mechanical rule-based trading pattern, once identified, can be anticipated with advanced computer systems to the HFT manager's benefit. But are all ETFs subject to HFT trading losses? As importantly, are ETF strategists passive managers?

ETFs based on a managed index such as the S&P 500 index, are not rule based and are theoretically immune from HFT trading losses. An index fund that is truly a market clearing portfolio is also by definition trading-price-neutral and can't be gamed. But any deviation of a rule based ETF from a market clearing index, however small, is at least theoretically, a non-price-neutral trade that can be picked off by an HFT. Factor-based index ETFs are particularly vulnerable to HFT trade limitations. But even traditional index fund ETFs are, to varying degrees, not price-neutral-trading funds and are not immune from HFT trading losses. So how should investment strategists limit their choices of ETFs?

The fact that the vast majority of ETFs are not trade-price-neutral implies that ETF strategists are not a passive investment strategy. The most important decision is how the fund fits into a well-formed well-diversified portfolio. An ETF manager is necessarily an active manager of a managed index of ETFs, in a controlled cost effective way. The choice of ETF indices, the construction of the portfolio of ETFs, and the choice of risk level for meeting objectives, all require investment expertise. It is the optimality of the portfolio allocations relative to goals that drive the value of an ETF strategy. The management fee is a rent on the manager's expertise and

*continued on page 5*

## New Frontier Portfolios

New Frontier develops and manages a broad range of ETF asset allocation portfolios for advisors and their clients, and currently oversees nearly $2 billion in global ETF asset allocation portfolios.

technology in providing an optimal investment.

Retirement investing puts a high premium on long-term reliable investing. But how can long-term reliability be optimized? Managers have hot streaks. Some managers are better in value markets, others when growth sentiment dominates. Few managers can claim added value over long-time periods and many fail in periods with fundamental changes in markets and politics. No manager is invulnerable to unforecastable risk.

Though diversification does not ensure a profit or protect against a loss, it is a valuable no-forecast strategy for dealing with unforecastable risk. Michaud optimization offers a unique patented process for enhanced diversification as reported in rigorous simulation studies. It has been a major factor in our effort to provide high quality investment strategies for more than twelve years in actual practice.

## YouTube Video Presentation

New Frontier continues to pioneer research in state-of-the-art investment practice. Our most recent published paper, "Deconstructing Black-Litterman," Journal Of Investment Management, 1st Quarter, 2013. A video presentation, co-sponsored by The New York Society of Security Analysts (NYSSA) and Society of Quantitative Analysts (SQA) is now available on YouTube, https://www.youtube.com/results?search_query=michaud+black-litterman. Many listeners will find the presentation readily accessible.

April 10, 2017

*continued on page 6*

Disclosures:

New Frontier Advisors, LLC ("New Frontier") is retained as a portfolio strategist ("Strategist") by unaffiliated companies ("Sponsors") that offer investment platforms to registered investment advisors or broker-dealers ("Financial Advisors"). As Strategist, New Frontier provides model portfolios to the programs that are designed to satisfy a set of investment objectives established by the Sponsors. New Frontier provides no direct investment supervisory service, investment management, or other investment advice to the Financial Advisors or their clients. New Frontier only provides regular investment management services to the Sponsors, generally on a non-discretionary basis.

The model portfolios are implemented by the Sponsors. Changes to the model portfolios, including but not limited to changes to the portfolio weights of the selected assets, are communicated by New Frontier to the Sponsors as necessary. The Sponsors or Financial Advisors are responsible for making any changes in their clients' portfolios based upon the changes in the model portfolio.

Because New Frontier relies on Sponsor quarterly data to calculate actual account-level monthly performance used for our long-term performance calculations, we do not have real performance data until the end of the first month of the subsequent quarter. For example, January, February and March performance data using real performance would be available by the end of April. To include quarterly performance in our commentary in a timely fashion, we take the portfolio weights throughout the quarter and calculate the daily total return for each portfolio based on publicly available ETF closing prices and distributions.

The performance shown is net of underlying ETF fees and trading fees, and we deducted estimated Strategist and Sponsor fees monthly at the expected highest fee rate. This includes reinvestment of income and deductions for transaction costs. It does not include advisory fees that may be charged by individual Financial Advisors, which may range from 1-2% per year. Thus the reported performance does not reflect the compounding effect of any such Financial Advisor fees.

Benchmark returns for the portfolio are blended returns of MSCI's ACWI IMI NR returns (stocks) and US Treasury Bills returns (bonds) according to the stock/bond ratio of the portfolio. This benchmark is used to reflect the global exposure of our portfolios while being denominated in U.S dollars.

The performance displayed here does not guarantee future results. As market conditions fluctuate, the investment return and principal value of any investment will change. Diversification may not protect against market risk. There are risks involved with investing, including possible loss of principal. Volatility represents the expected risk of the portfolio relative to major asset classes. Before investing in any investment portfolio, the Client and Financial Advisor should carefully consider the Client's investment objectives, time horizon, risk tolerance, and fees. The Financial Advisor assumes full responsibility for determining the suitability and fitness of each portfolio for their clients.

Before using these materials, please ensure that they comply with your firm's guidelines.