NEW FRONTIER

Market Perspectives: 2nd Quarter 2017

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

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On A Knife's Edge

Markets

The second quarter of 2017 closely mirrored the first. Global markets continued positive returns for many strategic domestic and global equity investors. All major domestic large cap indices are up for the quarter and the year: S&P 500 is up 2.6% for the quarter and 8.2% for the year, Dow is up 3.3% for the quarter and 8.0% for the year, and NASDAQ up 3.9% for the quarter and 14.1% for the year. In contrast, domestic small cap lagged larger indices with the Russell 2000 gaining only 2.1% for the quarter and 4.3% for the year. Diversified global equity performed well: ACWI gained 4.3% for the quarter and 11.5% for the year, and the ACWI ex-US gained 5.8% for the quarter and 14.1% for the year. International developed markets were mixed with the STOXX 50 returning a negative 1.7% for the quarter but still being up 4.6% for the year. Nikkei 225 erased its losses from last quarter returning 6.0% for the quarter and 4.8% for the year. Emerging market indices were stellar performers with the MSCI EM IMI index gaining 5.8% for the quarter and 18.1% for the year. MSCI EM IMI + A-Shares index, on the other hand, returned 4.4% for the quarter and 13.6% for the year. This disparity is due to a significant difference in performance between off-shore and on-shore Chinese equities. The SSE Composite is down 0.9% for the quarter and is only up 2.9% for the year while Hang Seng is up 6.9% for the quarter and 17.1% for the year.

Bonds and equity alternatives posted mixed results. The US AGG is up 1.5% for the quarter and 2.3% for the year. Dow Jones US Select REIT index is up 0.7% for the quarter but down 0.5% for the year. The US Dollar continued to weaken against major global currencies, declining 4.8% for the quarter and declining 6.3% for the year against the Pound; gaining 0.9% for the quarter but decreasing 4.0% for the year against the Japanese Yen; and against the Euro declining 6.7% for the quarter and 7.9% for the year. Gold, on the other hand, is down by 0.6% for the quarter but up 7.7% for the year. Due to global glut, oil significantly declined from last quarter end settling at $46.04 per barrel. VIX is at 11.18, it continues to remain below historical volatility levels. The 10-year T-Bill is at 2.31%. Global diversification has been a positive factor for New Frontier portfolios on a risk-adjusted basis.

Perspectives

With the market at historical highs, an inexperienced and controversial new President, continuing partisan political turmoil, contentious elections in Europe, and global religious and political terrorism, many investors may have understandably exited the market at the beginning of the year. If so, they may regret not being believers in the third longest economic expansion since 1850 or the second longest bull market in modern capital market history. Global stocks had one of the strongest half years in many years. Only four of the 30 major indices did not have positive returns since the beginning of the year. Improving economies, central bank support, rising eurozone

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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.

More information is available at www.newfrontieradvisors.com.

consumer sentiment, strong earnings growth, and a vigorous tech industry in the U.S. and China have all contributed to robust capital market returns.

In hindsight, it is strange that political turmoil since the beginning of the year did not affect the market. An extremely toxic political climate fostered by twitternomics and grim one-party rule policies is no safe road to a well-functioning economy. Yet the U.S. market seems to have hardly noticed.

It is a common psychological phenomenon that we fear what we don't know and don't understand. Even fair minded experienced investors were unfamiliar with a period of time that was largely dominated by global central bank macroeconomic policies. The Federal Reserve governors are virtuosos of modern macroeconomics, a discipline invented and refined since the lessons of the Great Depression. It was understood that the fierceness of the Great Recession required full bore application of the theory. It was all that stood in the way of a full blown global depression. The problem in application was that monetary macroeconomics, the weak sister of fiscal macroeconomics, was the only policy available due to political partisanship. The consequence was an unnecessarily slow grinding process lasting eight years when much of the suffering could have been avoided during the prolonged healing period.

The impact on capital markets of global central bank policy dominance has been surprising. The markets have been calm for many months. The VIX fear index has remained at historical lows. The average daily swing in the S&P 500 index in the second quarter has been 0.3%, the lowest in more than a half century.

Mainstream economists largely agree that the economy is experiencing relatively robust growth. Unemployment is low, job growth steady, and inflation low. The Fed is on course to loosen the reins and allow capital markets to slowly return to normal functioning. At the June meeting, the Fed announced another quarter point rise in short-term rates and the beginning of the process of bringing down the Fed's 4.5 trillion dollar debt.

The news from the eurozone continues to be encouraging. The French election was a welcome sign that euro politics will continue to be orderly, cooperative, and productive. There was growing political and economic consensus that Mario Draghi's stimulus program was getting traction. There was progress of agreement on Greek lending policy. Major eurozone indices were again positive for the quarter.

The news from China was largely positive. The popular MSCI Emerging Market Index would begin to include mainland Chinese stocks as a small portion of the index starting in 2018. While a small step in actual investing impact, it is an indicator of the slowly maturing character of Chinese capital markets. The good news from China is that new capital controls have become effective and the volatility of the currency has diminished.

The news from Japan in the quarter has also been encouraging. There is an effort to temper bond buying stimulus and allow the markets to function more normally. The

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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.

end result, so far, has seen better returns this quarter in the Japanese indices. There are many headwinds but also positive signs that government is aware and working to solve them.

Look Ahead

For the last eight years, investors have greatly benefited from well-informed globally coordinated central bank stimulus policies. Trillions of dollars have been injected into the major economies to encourage global economic growth and escape the ravages of the Great Recession. The end result of relentless bond buying policies and low interest rate management has led to amazingly low volatility in many capital markets.

The American economy, the lynchpin of global economic growth and capital markets functioning, continues to perform according to early recovery plans. Another rate hike is expected this fall and the policy of selling down the Fed's debt is in place. Low inflation spurred by low oil prices and productivity in the tech sector helped spur growth. Economic factors seem in good order and not likely to disrupt the market in the foreseeable future.

However, with stock indices at historical highs, there is a hair-trigger anxiety in the market. Are investors being complacent? Are we in a sugar high that could evaporate soon? If markets are ready to return to normal functioning, exactly what is the realistic fallback baseline? A glimmer of an end of the dramatic European Central Bank (ECB) stimulus policies emerged when some off hand comments by the ECB president Mario Draghi sharply spooked European markets and bond prices. It is possible that the robustness of the U.S. economy coupled with good economic and political news from global economies is the ongoing reality. Perhaps coordinated central bank macroeconomic policy has been more successful than understood.

For the foreseeable future, the major American economic risk is political. The level of anger by white low- and middle-income voters on national identity issues had no Clinton correlate. Russian meddling may not have affected actual voter count but did alter the political climate that enabled the Trump victory. Toxic political discourse is unproductive. The political imperative of satisfying the base results in a lack of focus on important non-partisan issues such as infrastructure spending and tax, immigration, and regulatory reform.

The good news is that much of the global economy seems to be in different but positive phases of economic healing. The politics of austerity is dead. The eurozone continues to provide positive signs of growth, with the markets responding accordingly. The political climate has stabilized with the French election. The hegemony of the eurozone seems safe whatever the consequences of Brexit. The Chinese government is well aware of its overleverage debt issues, and capital flight regulations have been moderately successful in managing the renminbi. The MSCI

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emerging market index news reflects the growing maturity of Chinese regulation and market activity. Japan has been able to moderate the need for current stimulus policies with the market rebounding a bit. While religious and economic terrorism, Middle East conflicts, military confrontation with Russia, and state sponsored cyberattacks can have dire consequences, they are unlikely to critically cripple global economic growth.

Passive vs. Intelligent Investing

It is a common academic mantra, and of a number of well-respected professional investors, that investing in an index fund is best for the majority of investors. There are two reasons for this view: 1) Experience has shown that active investment strategies charge more and perform less well on average relative to many common index funds; and 2) Twentieth century financial theory asserts that the "market" portfolio is efficient and investors should simply invest in a combination of the market portfolio and a low risk asset. We briefly examine both issues here.

Few active managers claim consistent performance relative to risk-adjusted benchmarks over time. Investors can do as well and pay less by investing in low cost index funds. In addition, the academic community asserts that the Capital Asset Pricing Model (CAPM), the dominant financial theory of the 20th century, holds that the "market" portfolio is mean-variance (MV) efficient. CAPM theory advises that investors invest in a market index fund relative to a low risk bond index fund at a level consistent with meeting long-term objectives. The convergence of modern financial theory and experienced professional advice has made a compelling case for passive index fund management for all but highly experienced investors.

One serious concern with the argument is whether the theory is correct. Dr. Harry Markowitz, the founder of modern finance, argues that the "market" portfolio is not MV efficient.[1] Does Markowitz's assertion make investment sense? Consider that informed investors have many competing perceptions of investment value: value vs growth, momentum, income, long-term, short-term, etc. All these many competing views of security value combine into an index that represents no one's efficient portfolio. The index fund is a committee's solution for which no one will claim ownership.

Index funds can surely claim the advantage of low asset management fees. But can finance claim contradiction of the axiom that an informed investor can't get what they pay for in an active investment strategy? While many investors are not well informed and many managers do not consistently perform to benchmark, is it true that all managers do not and cannot perform to benchmark on average consistently over time relative to fees? Perhaps there is a reason that can explain the paradox of general poor performance of active management relative to fees in the 20th century?

[1]Markowitz, H. 2005. "Market Efficiency: A Theoretical Distinction and So What?" Financial Analysts Journal, 6(5):17-30.

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Consider the state of modern medicine. Medical doctors now have access to many advanced technologies for treating and diagnosing patients such as MRIs, ultrasound, and laser treatments that were scarcely available even twenty and thirty years ago. In contrast, what technological advances have been introduced into contemporary asset management since the 1970s? While the market may be inefficient, the tools of active management may also be ineffective. From this perspective it should be little wonder that active managers are not able to claim persistent performance to benchmark relative to fees.

New Frontier's multi-asset core ETF strategies benefit from significant 21st century technological advantages. These include the patented Michaud MV portfolio optimizer and the multi-patented Michaud-Esch resampled portfolio rebalancing technology. Our multi-asset ETF strategies do not require that the index fund ETF is MV efficient. The index fund of an ETF is chosen to represent a well-diversified version of a global risk premium. Our strategies are efficient not because they use market index ETFs but because the portfolio of ETFs are Michaud MV efficient. It is worth noting that our ETF strategies are often highly ranked relative to competing alternatives over extended time periods.[2]

News

New Frontier founders Richard and Robert Michaud were featured in an article about the firm by Daniel Fisher in the June issue of Forbes Magazine, "Father (and Son) Know Best." Links and an abstract are part of the banner on our website: www.newfrontieradvisors.com.

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DISCLOSURES: Past performance 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.

[2]The Morningstar ETF Managed Portfolios Landscape Report includes comparative performance of many multi-asset ETF strategies over various time periods including New Frontier.

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