NEW FRONTIER

Market Perspectives: 3rd Quarter 2017

Enhanced Return ■ Effective Diversification ■ Managed Risk

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Glide Path

Markets

The third quarter of 2017 closely resembled the first half of the year – global markets continued to grow steadily, resulting in positive returns for many strategic domestic and global equity investors. All major domestic large cap indices are up for the quarter and the year: The S&P 500 is up 4.0% for the quarter and 12.5% for the year, Dow is up 4.9% for the quarter and 13.4% for the year, and NASDAQ is up 5.8% for the quarter and 20.7% for the year. On the other hand, domestic small cap underperformed large and mid-cap, with the Russell 2000 gaining only 5.3% for the quarter and 9.9% for the year. The difference in performance between domestic value and growth securities has continued to persist – S&P 500 Value index returned 2.8% for the quarter and 6.5% for the year, but S&P 500 Growth index fared better – 4.9% and 17.9% respectively. Diversified global equity performed well: ACWI gained 4.7% for the quarter and 15.4% for the year, and the ACWI ex-US gained 5.5% for the quarter and 18.5% for the year. International developed markets were positive as well, with the STOXX 50 returning 4.4% for the quarter and 9.3% for the year. Nikkei 225 continued its growth, returning 1.6% for the quarter and 6.5% for the year. Emerging market indices were stellar performers with the MSCI EM index gaining 7.0% for the quarter and 25.5% for the year. The SSE Composite more than made up for its losses from last quarter, returning 4.9% for the quarter and 7.9% for the year. Hang Seng, on the other hand, is up 7.0% for the quarter and 25.2% for the year.

Bonds and equity alternatives posted mixed results. The US AGG is up 0.9% for the quarter and 3.1% for the year. Dow Jones US Select REIT index is down 0.5% for the quarter and 1.0% for the year. The US Dollar continued to weaken against major global currencies, declining 3.1% for the quarter and 9.0% for the year against the Pound; gaining 0.1% for the quarter but still decreasing 3.9% for the year against the Japanese Yen; and against the Euro declining 3.3% for the quarter and 10.9% for the year. Gold, likely due to international geopolitical tensions, is up 3.0% for the quarter and 10.9% for the year. Oil somewhat rebounded from its earlier decline, settling at $51.67 per barrel. The VIX is at 9.51, continuing to remain below historical volatility levels. The 10-year T-Bill is at 2.31%. Given their global diversification, New Frontier portfolios' performance has been reflective of risk-adjusted appropriate global benchmarks.

Perspectives

The third quarter continued to reflect growth in domestic and international economies. Escape velocity, only aspirational a few years ago, has resulted in the continuation of one of the longest economic and bull market expansions in modern financial history. Aggressive monetary macroeconomic stimulus has probably been more successful than theorists had any right to expect. The U.S. and Europe have been in the hands of virtuoso macro economists that have lifted up the global

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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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economy back to grudging but robust health. Even with the handicap of immature financial markets and investors in China and demographic and cultural challenges in Japan, and in spite of geopolitical events rattling global economics, the global economy continues to add financial value.

It is worth noting the dominance of growth strategies relative to value during the eight-year period since the Great Recession. While growth was a top performing strategy, value was near the bottom. This phenomenon has persisted domestically and, to a lesser extent, globally for much of the period since stimulus packages were applied in the Great Recession. Even some prominent value managers have turned pessimistic as to the viability of value as a long-term investment strategy. But obsequies for value seem a bit premature. The coincidence between monetary stimulus and growth is likely more than random. In the context of a global efficient frontier framework used by New Frontier in its multi-asset ETF portfolios, value strategies remain an important component of optimal allocations at lower risk levels. However, value strategies may also increase in importance as global economies return to a more normal economic state.

In economics as in real life, nothing comes without cost. The U.S. monetary stimulus program resulted in $4.5 trillion in Treasury debt. As the debt level is drawn down, a return to more normal long-term rates and a slowdown in economic growth is likely to result. The U.S. is far from alone. Debt levels in the eurozone as well as China and Japan will continue to challenge the skills of macroeconomists and economic strategists. There are many risks beyond economic factors that could derail the process. Immigration, terrorism, instability in the Middle East, demographics, social and cultural rigidity, and political ineptitude can stop the hard won progress that has been achieved. It is unfortunate that so few politicians understand or are able to articulate economic imperatives so important to economic and social welfare.

However, not all is what it seems. While domestic market indices have continued to reach nominal market highs, a global perspective is valuable. In a recent article published in ETF.com, titled "When Market Highs Are About Perception," Robert Michaud noted that domestic equity indices, on a currency or purchasing power adjusted basis, have continued to decline since the highs reached in March 2017.[1] This perspective suggests coincidence with domestic uncertainty three months into the current political climate resulting from the health insurance debate, presidential tweets, and the Russia investigation. In particular, the evolving Russia investigations now include not only influence in the 2016 presidential election but continuing efforts to promote social divisiveness along cultural wedge issues such as racism and populism. An undercurrent of anxiety sponsored by hidden foreign agents may be having an effect on America's social and economic health. While the dollar rose this September, it remains down for the quarter and more than 7% for the year.

[1] Michaud (2017)

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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 $3 billion in global ETF asset allocation portfolios.

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The quarter was also afflicted by the very real potential of nuclear armed conflict. While too awful to contemplate, because it seems beyond rational possibility, nevertheless there is a continuing danger of miscalculation and the impact of random events. The financial impact has been visible in the volatility of gold and other haven assets. Note, however, that in spite of large geopolitical risks, the average daily volatility of the S&P 500 index was 0.3%, the lowest since 1968.

There is no room for complacency with respect to the current success of macroeconomic monetary policy. The enigma of persistently low inflation and pernicious employment patterns are serious concerns. Standard rationales include technological innovation, automation, low education levels, lack of skills, and cultural rigidities. Educational background and financial status can be serious impediments in the continuation of a globally competitive economy. While economic forces can't be legislated away without dire consequences, the transitional pain suffered by many left behind can lead to political upheavals in the social contract that threaten progress in economic growth.

Look Ahead

The mid-September Federal Open Market Commentary (FOMC) raised the expectation of one more short-term interest rate hike, probably in December, and three hikes in 2018. In addition, the Fed has begun retiring the $4.5T debt that it accumulated during quantitative easing (QE). Bond sales will include not only treasuries but mortgage securities as well. The Fed's policies for rescuing the domestic and global economy had never been implemented in practice. It will be of great interest to observe how the Fed manages the sale of mortgage securities, which are priced domestically, as opposed to treasuries that are often priced globally.

The monitoring of European Central Bank (ECB) QE bond buying policies are also of great interest. There are no eurozone-wide treasury-like securities for the ECB to implement QE policies. Consequently, the ECB not only buys eurozone government securities but also non-eurozone corporate bonds. Such policies are well beyond standard macroeconomic monetary theory. Consider the problem of managing not only euro but non-euro denominated securities. Though very limited in scope, such policies are necessarily fraught with unknown monetary risk.

The Republican Party will need to manage the political fault lines that emerged with the effort to repeal the Affordable Care Act (ACA) for its next important legislative initiative - tax reform. Tea Party, establishment, and populist or Trumpian Republicans often find little policy agreement. The President's support for a significant revision in taxes has boosted equity prospects and may have much bipartisan support, but investors are skeptical of anything substantive before the end of the year.

The global economy remains in a relatively stable and positive state. Most notably the U.S., but also other global economies, are on a glide path to more normal

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functioning capital markets. Multiple domestic hurricanes have resulted in devastating social and economic losses during the quarter. The economy is likely to experience a temporary slowdown in economic growth. Economic recovery and reconstruction will likely take months. The eurozone has begun to consider the end of QE stimulus and rising short-term rates. The Chinese economy has continued to manage a corruption campaign and capital controls, via currency management, that has allowed the economy to continue to grow. Japan is in the midst of an election that may fundamentally change its pacifist constitution and its ability to ramp up economic activity.

Geopolitical fears have not abated and have taken some ominous turns. However, as of this writing, U.S. and North Korea brinkmanship posturing has abated somewhat. The U.N. has voted for more sanctions, with Russia's and China's concurrence. The proposed Trump trade war with China has taken a back seat to the importance of their help with North Korea. Unfortunately, horrific terrorism incidents continue in Europe. Revelations of Russian misinformation campaigns on cultural wedge issues are still emerging.

Intelligent Strategic Investing

For the last twenty-five years, the strategic investing mantra has been that long-term asset allocation risk policy is the single most important investment decision. Risk policy is usually defined as the stock/bond ratio of the asset allocation.[2] Many large financial intermediaries as well as financial advisors consider asset allocation risk policy as dominant in long-term portfolio investing.

The research associated with strategic investing policy is based on Brinson, Hood, Beebower (1986).[3] They were the first to examine the long-term performance of institutionally managed pension plan portfolios. They reported that 94% of the variance of institutionally managed portfolios was associated with the stock/bond ratio of the portfolio. They also found that the two other components of performance, fund selection/management and market outlook, were negatively related to long-term return.

The Brinson et al studies were a shock to institutional investment community. Their results were totally at odds with what institutional asset managers had believed. Policy, not active management, was the only important factor in managing long-term portfolio return. The results were viewed as confirmation of the academic notion of the Efficient Market Hypothesis (EMH).

[2]The more modern version is stock/non-stock ratio. This is because mortgages, commodities and other fixed income asset classes are also often included in the definition of asset allocation risk policy.

[3]The follow up study Brinson, Singer, Beebower (1991) extended the data and confirmed the original conclusions.

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In an often neglected study, Hensel, Ezra, Ilkiw (1991), using a separate though similar database, also examined the long-term performance of institutionally managed portfolios. They noted that the Brinson et al studies were interpretable as the importance of asset allocation risk policy relative to riskless rate investing. In their study they decomposed the components of long-term asset allocation portfolio performance focusing on the stock/bond ratio decision, fund management, and market outlook. In contrast to Brinson et al, they find that the stock/bond decision and fund management were equal in importance, each representing roughly 40% of portfolio variance. Market outlook was attributable to most of the remaining 20% of portfolio variance.[4] They also noted, as in Brinson et al, that fund management and market outlook were negatively related to long-term return.

In hindsight, the nearly universal acceptance of the Brinson et al results may seem surprising. Why would anyone dismiss portfolio management or market outlook as insignificant in long-term asset allocation performance? One reason may have to do with effective marketing campaigns by consultants of policy based strategies. Another has to do with the iconic academic authority of the EMH. However, even accepting Hensel et al as the superior study, no component of performance other than the stock/bond ratio decision affected return in a positive way.

An alternative to the EMH consistent with similar evidence seems important for the investing community to consider. Perhaps the market is not informationally efficient but that asset management is deficient. For example, Michaud (1989) noted that traditional portfolio optimization is ineffectual because it does not consider the statistical uncertainty of risk-return estimates in investment information. Consequently, even in the presence of valid investment information, the limitations of traditional portfolio optimization would likely limit any benefit.

Asset management technology needs to show evidence of additive investment value. New Frontier multi-asset core ETF strategies benefit from significant 21st century technological advantages. Simulation tests show that the Michaud optimizer is superior out-of-sample compared to traditional portfolio optimizations.[5] In addition, the Michaud-Esch resampled portfolio rebalancing technology is the first of its kind to use portfolio similarity methods to decide when rebalancing may be advisable on a statistical basis.[6] It is worth noting that our ETF strategies are often above standard benchmarks and highly ranked relative to competing alternatives over extended time periods.[7]

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[4]Ibbotson and Kaplan (2000) confirm the Hensel et al decomposition of long-term portfolio performance.

[5]Michaud (1998)

[6]Michaud et al (2012)

[7]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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