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Comments on the June 2013 Selloff

by Dr. Richard Michaud

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Investors have nervously anticipated the end of the Federal Reserve policy of stimulating U.S. economic growth with quantitative easing (QE3). The June 19th report by the Federal Reserve Chairman on the state of the economy reflected an unexpectedly positive view of the recovery. As a result, the announcement anticipated ending QE3 by the middle of 2014. The report was seen by many as a signal of near term higher interest rates. A dramatic and widespread global selloff resulted. While Bernanke's comments were most applicable to U.S. treasuries, they resulted in large declines in prices for nearly every major global asset class.

Our investment policy committee convened early this week to address the changes that the global selloff and a sharply changed interest rate environment implied for our investment strategies. Fixed income allocations were a particular focus.

Although we do not attempt to predict future asset prices, current Treasury yields are explicit inputs to our optimization process as are up-to-date volatilities and correlations. There are two main sources of yield for bonds: duration and credit exposure. Duration reflects sensitivity to changes in interest rates, a risk factor we carefully monitor. Credit risks are often related to equity risks and credit spreads have been relatively low due to the downward pressure on yields.

As a general rule, selling in a selloff is often a poor investment decision. Fear driven market timing has proven to be one of the least successful investment strategies. In addition, trading during highly volatile times can be expensive. One of Warren Buffet's most useful investment insights is his comment that where there's fear, there are returns to investment risk. Acting on fear can make you feel better in the short term, but it almost always hurts your performance in the long term.

The committee's review of the New Frontier global strategic portfolios determined that almost any significant changes in our Michaud optimized fixed income asset allocations, short of going in to cash, would likely have increased the risk and reduced return during the selloff. In particular, neither credit risk nor emerging markets were a fixed-income safe haven.

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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.

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Things to remember:

- Risk and return are linked. There are no free lunches in finance other than a well-diversified investment strategy.
- We diversify across all identifiable risk premia, duration and credit, as well as the equity risk premia.
- Trading on fear has historically been a poor investment strategy.
- Globally diversified portfolios remain the most reliable way to participate in long-term growth in capital markets.

This note was posted as an entry on New Frontier's investment blog on June 27, 2013. Read this entry and other posts at: newfrontieradvisors.com/blog.