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Oil, Currencies, and the Fed

Markets

Fourth quarter headlines included volatility spikes, dramatic declines in oil prices, and positive views of the economy by the Fed. Oil declined 41% this quarter and 46% for the year. The dollar continued to gain against some major developed global currencies. For the year, the dollar gained 13.6% against the euro and 13.8% against the yen while gold was down 2%. There were substantial signs of a healing U.S. economy while U.S. stocks rose into or near record territory. The Dow was up 4.6% for the quarter and 7.5% annually, the S&P up 4.4% quarterly and 11.4% annually, the NASDAQ up 5.4% quarterly and 13.4% annually. On the other hand, international investing was challenging. The ACWI ex US was down 4.2% for the quarter and the year down 6.3%. More specifically European equities were down 4.6% for the quarter, Pacific equities 2.4%, and emerging market indices down 4.8%. China was a major exception with the China ETF in our portfolios up 4.8% for the quarter. The U.S. remained the global reserve currency of choice. The Barclays Aggregate Total Return index was up 1.9% for the quarter and 6% for the year. Confounding virtually all analysts' 2014 predictions, long-term treasuries were stellar performers: up 9.3% for the quarter and 27.3% for the year. In addition, domestic REITs continued a strong year, up 15% for the quarter and 32% for the year. Though ending at a nominal value of 19, it was a volatile quarter for the VIX. All New Frontier's portfolios were positive for the year, returning between 5% and 8.5%. Moderate risk targeted portfolios performed best this year.

Perspectives

For global investors, the most relevant factor was the continued progress of a healing American economy with patient steady support from the Federal Reserve. The Fed's pump priming policies coupled with the Bush-Obama stimulus packages took root, resulting in a slow but steady turnaround from the depths of the Great Recession. Up until recently job growth has been one of the most serious residual concerns. However, the latest reports show that the four-week average of initial jobless claims has been below 300,000 for the last four months. That compares with over 650,000 claims at the peak of the recession. While the most recent report showed a small uptick, such estimates are particularly volatile around the holiday season. Adjusted for the size of the U.S. labor force, the number of recent filers has never been so low.

From an economic perspective, output growth rose at an annual rate of 5% during the summer months. This followed a second quarter growth rate of 4.6% after a decline last winter affected by particularly bad weather. This latest estimate featured a rise in business investment and higher consumer spending. Positive growth signs included equities reaching new historical highs, steady inflation, Treasury yields declining, and the dollar advancing relative to almost all major currencies. Contradicting a

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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.

continuous barrage of misinformation from consultants and pundits that kept many investors from participating in the run up, investors have finally come to realize that the last six years was not a secular bear market but its inverse; one of the longest secular bull markets in financial history. There is reason to believe that future pullbacks may be shallow since much money has remained on the sidelines and many may wish to finally participate in this historic bull market.

International investors have had much less to cheer. The European economy remains stagnant with serious risk of a deflationary spiral. Investors need look no further than the 10 year German Bund yield of 0.5% to demonstrate there is simply no demand for credit in the most important and robust eurozone economy. Eurozone inflation is 0.3%, far below the 2% target. Geopolitical factors were little help. Russian militarism and the threat of cutting off gas supplies added volatility to European markets. The Bundesbank has long prevented the European Central Bank (ECB) initiating a quantitative easing (QE) policy similar to the Federal Reserve. However, unlike the U.S., QE in the eurozone requires asset purchases with political credit and fiscal risks that may significantly limit effectiveness. There is hope in the status quo with sharply lower energy prices and a declining euro to boost competitiveness. Alternatively, a Greek exit from the euro may be what is required as a catalyst for fundamental changes in the European compact.

For Chinese capital markets the central issue is risk. Chinese policies for modernization of their financial markets imply reducing controls on the yuan in the context of a strengthening U.S. dollar and slowing economy. While U.S. based Chinese equity ETFs performed roughly in line with U.S. benchmarks, the Shanghai benchmark index is up 50% this year. This performance disparity reflects many issues. Much trading is done on margin by Chinese nationals inexperienced with equity risk in markets with immature regulatory controls. The buying frenzy is related to the fact that there are few alternatives for investment particularly given the potential of an enormous bubble in the property market.

In Japan, the recent election maintained the ruling coalition's two-thirds supermajority and may make Shinzo Abe the longest serving prime minister in half a century. Abe has been given much credit for ambitious efforts to break the country's long cycle of economic decline using methods similar to those of the Federal Reserve's QE and Bush-Obama style stimulus policies. He has a mandate to continue a program of reform and sustainable growth in the world's third largest economy. Important positives include sharply lower yen and energy prices. Nevertheless it is not a simple task. Headwinds include Japan's rigid corporate and labor structure. Japanese corporations operate with rigid labor laws, are culturally resistant to change, and reluctant to exit underperforming businesses. Firing employees is difficult and expensive and restructuring is a seemingly endless process. Abe's success depends on persistence, patience by the Japanese electorate, and luck.

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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.

Many important emerging markets have been victimized by a sharp decline in oil prices and a rise in the value of the dollar. Many high debt companies and their governments are at risk for high debt levels. Major concerns exist not only for Russia but also Brazil, Mexico, Turkey, Venezuela, and Argentina. Given the prospect of rises in U.S. interest rates in the foreseeable future, contagion effects could spark a sell-off in the sector.

Look Ahead

In its December announcement, the Federal Reserve's relatively upbeat view of the American economy is good news for global investors. The Fed shared that "the committee considers it unlikely to begin the normalization process for at least the next couple of meetings." Consequently short-term rates are unlikely to rise until at least the middle of 2015 and possibly not until 2016. The stock market rose sharply after the Fed released its "patient approach" statement. However, a soft global economy continues to represent strong headwinds for growth.

U.S. government bonds continue to benefit from the global investor view of an American economy picking up steam as well as the safe haven reserve currency of choice. Treasuries benefit from the volatility in global currencies, geopolitical events such as Russian and Middle East militarism as well as the fall in oil prices. Confounding pundits, consultants, and soothsayers, long-term treasuries were some of the best performing 2014 major asset classes with the 10 year yielding 2.17%. However, investors need to remain vigilant of knock-on effects of a relatively near-term rise on short-term yields for all income oriented securities.

Many investors now consider exchange traded funds (ETFs) as the modern way to invest in low risk well-diversified indices. Recent ETF popularity has greatly benefited from a rush for exposure to the U.S. economic recovery. Assets under management currently total \$2.8tn. There have been some concerns in the media of ETF tracking in sharp volatility high redemption periods with less liquid assets. Such issues are necessarily part of thoughtful monitoring and evolution of capital markets. New Frontier avoids such concerns with infrequent slow-trading strategies using state-of-the-art Michaud-Esch patented rebalancing technology.

A new Republican majority in both houses of Congress raises some hope of a more effective legislative agenda. On the other hand, the last six years of legislative gridlock were contemporaneous with a historical bull market reminding some of Will Rogers's aphorism: the only dangerous time in American life is when Congress is in session. More generally global risks include the geopolitical consequences of sharply lower oil prices, continuing cyber and religious terrorism, and militarism in the Ukraine, Middle East, China, and North Korea.

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2014 ended with a burst of buying activity with many managers window dressing their portfolios to avoid being seen as left behind from the market's climb. Roughly 90% of active managers this year are behind their S&P 500 benchmark, perhaps the worst year for active management on record. Active mutual funds continue to decline in interest while passive funds continue to grow driven, in part, with increased interest in index ETFs. Hedge funds are flat as a group and many hedge fund managers and liquid-alternative funds have suffered grievous losses this year.

While active and tactical asset management has been in steady decline for many years, it is not likely to totally disappear. The value of information isn't zero and optimal choices for investors in a well-defined investment program may be hybrid strategies that carefully integrate the benefits of active and passive. What has been ignored in many discussions of active management dysfunction is the role of ineffective investment technology. Good investing is not simply a collection of quality investable assets. It also requires optimally using investment information for effective portfolio construction and rebalancing relative to objectives. In one of the most consistently downloaded papers in finance, Michaud (1989) noted that portfolio optimizers typically don't add value and may often be worse than equal weighting. If there are no portfolio allocation procedures that demonstrably add value, it is vacuous to argue for sophisticated analytics, exotic return distributions, or behavioral biases as rationalizations for the limitations of active asset management. Provably effective investment technology is a necessary condition for active management success. This is the essential rationale for New Frontier's continuing extensive research agenda in developing and refining Michaud optimization and Michaud-Esch rebalancing for asset management.

New Frontier Research

A new working paper by Richard Michaud, Robert Michaud, and David Esch entitled: "The Fundamental Law of Mismanagement," is now available for download on our website and on SSRN and ResearchGate. In this paper we show that the fundamental principles of active management that have been used for developing equity portfolio strategies for more than twenty years, including many long-short and hedge fund portfolios, are invalid. This important paper is part of our ongoing research program of avoiding ineffective investment technology while developing provably effective state-of-the-art patented procedures for asset management.

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