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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.

The Economy, the Fed, and Politics

Markets

It was a good quarter to invest in equities, and despite a down second quarter, overall a good year as well. The Dow was up 1.5%, the S&P 4.7% and the NASDAQ 10.8%. Year-to-date returns were very positive with the Dow up 15.5%, S&P up 17.9%, and NASDAQ up 24.9%. International equities were also positive for the quarter and year with the MSCI ACWI ex US up 9.4% and up 7.5% year-to-date. While emerging market equity indices were up 5% for the quarter they remained negative -6.4% for the year. Notably, China made a remarkable recovery. The China ETF in NFA's portfolios is up 15.5% for the quarter and positive 2% for the year. Fixed income indices were mixed with the Barclays Capital Aggregate Total Return bond index up 0.6% for the quarter but down 1.9% for the year. The VIX remained a relatively modest 16.6%. The dollar declined 3.9% relative to the euro quarter to date and 2.3% year-to-date. The dollar declined 0.9% against the yen for the quarter but up 13.5% for the year. New Frontier's global strategic portfolios total returns were up 1.8% to 8.1% for the quarter and up 1.2% to 14% for the year depending on equity exposure.

Perspectives

The media has been obsessed with Federal Reserve announcements on possible tapering of the QE3 stimulus program. A global market selloff resulted from the June 19th Bernanke testimony of a possible early start to tapering of the stimulus program. The September 16th Fed announcement that economic conditions had not improved sufficiently and that the stimulus program would continue without change surprised many investors, strategists, and pundits. In an earlier statement to our investors, we noted that tapering may be some months away due to a weaker than expected labor report in August and significant downward revisions in July and June. In addition, the Sequester continues to limit the strength of the recovery while major political obstacles to economic growth in the form of a possible extended government shutdown and federal credit default loom.

Trigger happy trading frenzies are often associated with a perception

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.

that the Fed's stimulus program has little substantive economic content beyond printing money leading to unsustainable sugar highs in markets that deflate when tapering begins. Our view is that a well-managed stimulus program is a necessary pump priming process for restarting economic activity in the continuing aftermath of the 2008 credit crisis. In this alternative perception, capital market valuations at any point in time may largely reflect economic reality valuations relative to contemporary risk factors absent short-term trading volatility. A thoughtfully aware and disciplined investment process may be most successful in managing the economic risks during such transition periods. The unfortunate consequence of the obsessive media hype by pundits and strategists on the Fed's stimulus policies has caused many investors to be unhappy recipients of highly whip-sawed investments.

The Federal Reserve's monetary policy is a rational factor affecting domestic and global markets. However, the dominating risk for capital markets at the end of the third quarter is an irrational and unpredictable factor concerning the possibility of an extended government shutdown and federal credit default in the middle of October. Martin Wolf described the situation as "America Flirts with Self-Destruction."¹ Federal credit default alone, even momentarily, could toss the fragile U.S. recovery back into recession with unknown long-term consequences. Even simply threatening federal credit default as part of a political gambit is likely to be harmful short- and long-term. The less pernicious but still very serious government shutdown, extended for any significant time, will grind down the progress of the fledgling recovery and extend higher unemployment and low growth for possibly months to come. The world economy depends on the unquestioning quality of American federal debt. The consequences of the extended shutdown and the possibility of federal credit default are unforeseeable and could be catastrophic.

Look Ahead

Up until now, capital markets have largely been complacent of the consequences of a government shutdown and the possibility of federal credit default. Consensus is that the risks to the domestic and world economy are too great and Washington politicians will come to their senses. The end game by almost universal reckoning is that the effort to

¹ *Financial Times*, October 2, 2013, p. 11.

New Frontier Portfolios

New Frontier develops and manages a broad range of ETF-based asset allocation portfolios for advisors and their clients, and currently oversees over \$1 billion in global ETF asset allocation portfolios.

hold the American economy hostage by a small cadre of political terrorists is unlikely to succeed. While the shutdown has no known end point, as of this writing it appears that breaching the federal credit debt limit this quarter is unlikely.² However, investors should carefully assess the risks that the current political climate imposes on the near-term American and world economy. The right answer, long-delayed rational budget legislation, remains seemingly remote.

The great bull market in bonds is often forecast to be coming to an end. Yields are so low that prices will inevitably have to adjust. But will managers sell bonds in substance and rotate into stocks? Many fund managers remain over weighted in cash. Individual investors remain spooked by equity volatility and continue investing in bonds as a way of managing portfolio risk. In addition, many investors may be in no rush to sell bonds at significant losses as interest rates rise. Consequently, various natural regulator systems in global capital markets suggest that radical and wholesale changes in asset allocations from bonds to other assets may be unlikely.

The quarter provided renewed appreciation of the benefits of relatively independent sources of economic growth opportunities. European markets outperformed many domestic indices and exhibited relatively limited volatility. Asian markets were also strong performers in important cases. Chinese equity markets have made a remarkable turnaround. The Abe stimulus experiment has shown some encouraging signs of reviving the moribund Japanese economy. Emerging markets have improved this quarter. International markets are likely to grow when world economic growth rates return to normal levels. However, the eurozone's monetary structural limitations leave many obstacles for long-term resolution. The Middle East continues to be volatile. The interconnectedness of global economies elevates the risks and opportunities for everyone.

Our strategic portfolios undergo continual assessment of market and economic risks. Our unique diversification technology provides effective long-term risk managed portfolios. Optimization design is focused on portfolio risk characteristics for meeting contemporary challenges in capital markets. Fully invested effectively diversified global portfolios are unlikely to miss turnarounds consistent with a belief in long-term global economic growth.

² "Boehner Tells Republicans He Won't Let the Nation Default," *NYTimes*, Oct. 3, 2013, 12:45 pm.

continued on page 4

Strategic Asset Allocation and the Paradox of Bond Investing

Fixed income funds have many important functions in global capital markets. Life insurance companies may buy long-term bonds to hedge long-term life insurance policies. Commercial insurance companies may purchase intermediate-term bonds to hedge various shorter-term liabilities. Pension funds may buy various maturity bond funds to match vested retirement liabilities. Central banks may use various maturity fixed income funds to manage macroeconomic risks.

However, the role of bond investing for investors with long-term strategic goals is arguably controversial. This is because, on average, bonds underperform stocks. Historically stocks outperform bonds roughly 70% of the time and there are few non-overlapping five year periods in American financial history where bonds have outperformed stocks. Therefore, why not ignore bonds and invest solely in equities? As importantly, why is the performance of large generic bond funds appropriate as a low risk return benchmark for strategic investing?

The paradox of bond investing in strategic asset allocation has a simple explanation and interesting implications. In an optimized asset allocation the role of the fixed income fund is not to add return relative to risk as a standalone asset but to optimally hedge overall portfolio risk at each point of the efficient frontier. As a result the risk characteristics and performance of the component fixed income portfolio will generally deviate significantly from generic bond indices. Fixed income investing in a strategic asset allocation should be defined within an optimized portfolio context and does not depend on whether or not bonds outperform stocks on average over time. The interesting implication is that traditional comparisons between the fixed income component of an optimized strategic portfolio and generic fixed income funds are generally invalid.³

Coming and Recent Research Presentations

Robert Michaud will present his new paper on Low Volatility Investing at New York QWAFEFW, November 13. Richard Michaud, David Esch and

³ Comments are based on personal communications with Robert Michaud.

continued on page 5

Robert Michaud have recently presented their paper, “Deconstructing Black-Litterman: How to Get the Portfolio You Already Knew You Wanted,” at the *Journal Of Investment Management* (JOIM) Conference, September 8-10, Napa California. Richard Michaud will also be presenting the paper, “Deconstructing Black-Litterman,” at CFA Houston on October 16, CFA Fort Worth and CFA Dallas on October 17 and Princeton QWAFEFW on November 19.

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