NEW FRONTIER

Market Perspectives: 3rd Quarter 2011

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

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Market Turmoil

It was the worst quarter for equities since 2008. Global equities were down 17% for the quarter and 14% year-to-date while the S&P was down 14% quarterly and 9% for the year. European equities were the worst performers down 23% this quarter and 16% year-to-date while Asian indices were down 12% quarterly and 14% for the year. Not a single Dow Jones Country Global Index reflected positive U.S. dollar returns in the quarter. On the other hand it was a good period to be diversified in bonds. Domestic bond indices were nearly universally positive. Long-term treasuries were up 29% quarterly and 31% year-to-date, intermediate treasuries 10% and 14%, TIPS 5% and 11%. The VIX rose from 16% at the beginning of the quarter to over 40%, vividly illustrating the level of uncertainty in current capital markets. The dollar gained 8% against the euro but fell 5% against the yen while oil fell 17% this quarter.

Perspectives

A promising market expansion was stilled by ugly politics in Washington and Brussels. While both domestic and European crises were largely political rather than economic, the consequences rattled investor confidence in capital values worldwide.

As in the U.S., agency issues are the root cause of the European debt crisis. The U.S. subprime mortgage crisis resulted from agents paid to issue mortgages without responsibility to consider the ability of borrowers to pay back the loans. Similarly, European bank agents ignored the default risk of euro-based Greek government and private debt based on the implicit guarantee of the European Union (EU)'s support of the euro. Greece's bloated public sector, endemic corruption, poor tax collection, and minimal history of growth dynamism was little dissimilar to subprime lending to out of work individuals.

European politicians are understandably reluctant to bail out Greece and European banks with taxpayer money, even though Greece's membership in the eurozone benefited exporting economies. However, failure to fund a Greek bailout or to allow a disorderly departure from the eurozone is very likely to have a knock-on effect on all eurozone banks, eurozone economies, global economies and capital markets worldwide. A worldwide recession could easily result. Timothy Geithner called it a "dominant" concern. As Raghuram Rajan, former Chief Economist at the International Monetary Fund (IMF) noted, "You can't underestimate the problems that could emerge if the troubles in Europe aren't contained. It is going to spread to the U.S. quickly."

Where will the money for a Greek bailout come from? The current

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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**.

proposal is that the European Financial Stability Facility (EFSF) acts as a eurozone treasury working with the European Central Bank (ECB). But will it be able to operate by qualified majority vote rather than unanimity? In the most likely default scenario, will the European Union be able to mandate a 50% haircut for Greek bondholders and a recapitalization of the banks? Is the amount of funds required for guaranteeing bailout for Greece and other countries feasible? Such questions remain at the heart of whether the European debt crisis can be contained, the euro saved, and whether the European community can act in time to be effective.

Not since Alexander Hamilton had a U.S credit default been a serious threat in global credit markets until last July. The issue was political not economic. The downgrade did not reflect whether the U.S. government could pay its debts but whether it was willing to do so. As a result, U.S. government debt is no longer perceived as the good-as-cash investment it has been. This is bad news for the American economy long-term. While the European debt crisis, a global economic slowdown, and sharply declining equity markets have captured the headlines, the consequences of the uncertainty in U.S. government debt, now that it can be held hostage to political calculation, is likely to have serious negative long-term implications for the competitiveness of the American economy.

The U.S. dollar as a global investor haven is well correlated with the no-end-in-sight eurozone problems and its implications for risk assets all over the world. The recent downgrade of Italy's credit rating raised the specter of a much broader European debt crisis. While U.S. growth is weak, the demand for liquidity can surpass the importance of fundamentals. In this dramatic flight from risk, even the yen is also a haven. While of positive benefit to the U.S. economy overall, it is not necessarily good news for equities.

Mr. Adoboli, who worked at the UBS Delta One trading desk tracking exchange traded indices in London, has been accused of over $2B in unauthorized investments in equity index futures and concealing them from internal risk controls. His activities highlighted the fact that trading desk practices often lack transparency and provide continued impetus to bring derivatives, counterparty transactions, and other privately traded instruments onto exchanges. New Frontier's ETFs are chosen to reflect the highest quality diversified index funds in order to minimize the need for risky tracking practices and provide the most reliable investments possible.

Look Ahead

Investors were alarmed by the Fed's view of substantial downside risk and the need to consider using one of the few tools it has left to stimulate growth in the near term. The Fed's Operation Twist in effect buys long-term and sells short-term treasuries. The proposal includes continued support for

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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.

the mortgage sector and does not require an increase in the Fed's balance sheet of treasuries. The essential purpose is to drive down long-term yields and encourage purchases of more risky bonds and possibly stocks.

No long sustained business expansion is in sight. The continued high unemployment rate provides little reason to hope for any significant recovery for the foreseeable future. Most private economists have revised their estimate of GDP growth downward in the 1.5% range. Job growth halted entirely in August. The probability of a second recession is increasing.

In a time period with high economic stakes, politicians formulating economic policy and focusing on debt reduction are often at odds with working macroeconomists who generally emphasize encouraging growth and reducing unemployment near term. Recently the IMF warned of the serious consequences of the slowdown of economic growth in the world economy due to political overemphasis of austerity policies. While a proponent, Fed chairman Bernanke recently noted that Chinese currency policy is blocking the normal global recovery process and may limit the effectiveness of stimulus tools.

There is some positive news. A controlled Greek default with the eurozone muddling through is a likely possibility given the alternative. American corporations are cash rich, and earnings yields are robust. The remarkable American economy may continue to slowly recover. Some comfort can be taken that few private economists currently forecast a likely second recession in the U.S. In particular, it would be odd to have a recession in a presidential election year.

Investors have rightly been concerned about the extreme volatility experienced in U.S. and global equity markets. Swings of 3 and 4% have become almost commonplace. Are equity markets in a new normal phase? Investors should be aware that computer-based High Frequency Trading (HFT) and Algorithmic Trading (AT), which involve durations of as little as 10 milliseconds, is often up to 75% of equity trading in U.S. and other global equity markets. Proponents claim that HFT and AT correct trading errors and reduce trading costs for many traditional investors. On the other hand, HFT has been cited as the primary cause of the May 6, 2010 flash crash. AT and HFT strategies may monitor news feeds in real time and legally front run many conventional investment strategies. At a minimum, computer trading speeds up information transmission that may often result in sharp swings in index levels. The long-term consequences of computer trading on asset management and capital markets have yet to be fully understood.

This is the type of market that may benefit those who have a well-thought-out strategy of risk that suits long-term objectives. It can be an opportunity to rebalance against excessive and possibly irrational or ephemeral volatility. If the market goes down more, you buy more and take advantage of the dips to get a better long-term return. But, for shorter-term investors, much

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depends on the risk factors in Europe being addressed and the political issues at home. Given grudging action in evidence so far, the European debt crisis could easily fester for many months or even years. In addition, resolution of political risk in the U.S. is more than twelve months away. The VIX currently represents a level of capital market risk consistent with the depression era. Consequently, shorter-term investors may want to consider whether current portfolio risk levels are appropriate in the light of the global economic environment. We note that each New Frontier ETF model portfolio is optimized for its risk level and serves as an optimally efficient alternative for managing portfolio risk.

Recent experience confirms the fundamental importance of effective risk-appropriate globally diversified portfolios for meeting core investment objectives. An effectively diversified portfolio can be a valuable component of a well-defined investment program for many investors. Innovation remains the ultimate source of economic growth in global capital markets.

Research News and Announcements

The 4th quarter issue of the *Journal Of Investment Management* will feature an interview of Dr. Harry Markowitz by Dr. Richard Michaud. Harry Markowitz is a true giant of modern finance and economics. His list of seminal accomplishments defined the birth of modern finance and continues to guide it into this century. The interview traces his work from portfolio diversification, computational finance, utility theory, and foundations of the CAPM, to long-term investing, return distributions, tests of Michaud optimization, and recent results on the limitations of traditional security risk measures and the importance of the entire efficient frontier for asset management.

Dr. David Esch, New Frontier's Director of Research, reviews some fundamental innovations he has developed and introduced in New Frontier's asset management and portfolio optimization software. Each innovation represents the state-of-the-art in contemporary investment management technology. All of David's new procedures are being employed in our global strategic model portfolios. David's note is featured on our website and can also be accessed at http://www.newfrontieradvisors.com/Announcements/documents/NewFrontierOctober2011.pdf.

October 6, 2011