



**Dr. Richard O. Michaud**  
President and CIO,  
New Frontier

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 4 U.S. patents and author of *Efficient Asset Management* and many professional and academic articles.

## Treading Water

For the quarter, domestic equity indices managed small gains or losses while holding on to substantial returns year-to-date. The Dow was up 1.4% for the quarter and 8.6% for the year. The S&P and NASDAQ were both almost flat for the quarter, up 0.1% and down -0.3%, but up 6% and 4.5% for the year. A dominant factor from a U.S. investor's perspective this quarter was a more than 2% decline in the dollar versus the euro and yen. In dollar terms, European indices were up 2.4% for the quarter and 9% for the year, while Asian indices were flat for the quarter but down -2% year-to-date. Bond indices performed well in the quarter. A number of diversified bond indices were up nearly 4% for the quarter and for the year. Oil prices were down -10% in the quarter while the VIX remains at 16%.

NFA's globally diversified equity and fixed income risk-targeted ETF portfolios performed as designed. Portfolio risk was well diversified and systematic levels well correlated with performance.

## Perspectives

In March's commentary, we noted that the dominant risk factors in global capital markets were more political than economic, notably the possible Greek and U.S. debt default. An elevated level of uncertainty continued to afflict capital values during the quarter. Macro events involving currencies, a surge in energy prices, signs of a weak recovery, and potential debt defaults whipsawed capital markets. Investors had few convictions, and large directional bets were mostly absent.

As the quarter drew to a close, the Greek default situation appeared to be stabilizing. The Greek parliament agreed to austerity measures that allowed a bailout package from the European Union and International Monetary Fund. Many of Europe's largest banks signaled willingness to take write-downs on their Greek debt in order to lay a more sustainable debt solution. On the other hand, the obviously self-serving plan for European investors may still be considered a "selective default" by ratings agencies with unknown consequences. Warning signs keep flashing. In addition, there seems little doubt that the riots in Greece and the political risks of continued support of austerity programs are unlikely to abate anytime soon.

Negotiations associated with raising the U.S. debt ceiling are reaching a critical stage as of this writing. According to official reports, the Treasury will be unable to meet all its obligations after August 2<sup>nd</sup>. Since Alexander Hamilton, the U.S. has never defaulted on its debt obligations. The potential havoc in global credit markets and consequences for the

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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](http://www.newfrontieradvisors.com).

## 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.

viability of the dollar as the global reserve currency is in play. John Chambers, Standard and Poor's managing director, noted that the ratings agency would cut the U.S.'s credit rating to "D" from its current "AAA" standing if the government fails to raise the debt ceiling by August 4, and a payment is missed. The polarizing effect of the economic crisis is at the center of a high stakes political calculation related to out-of-control public finances that could severely affect the nascent economic recovery and the economic health of the American economy for many years to come.

The Federal Reserve's stimulus QE2 policy ended as promised. The politically controversial policy was, by many measures, very successful. Since the start, only 3 Dow and 28 S&P stocks are down. Every S&P sector reported a double digit gain. Though the Dow remains 12% below October 2007 levels, many small and mid cap stocks have returned to their October highs.

## Look Ahead

The economic upturn began in mid 2009. While unemployment remains high, corporate balance sheets are healthier, Wall Street de-leveraging is proceeding, savings rates are up, and many strategists currently consider equities cheap. The lackluster performance of domestic equities in the quarter was primarily associated with negative returns in financials, a symptom of the continuing de-leveraging process and new regulations worldwide. However, the underlying conditions for a long sustained business expansion do not seem in-place. A cyclical expansion, typically lasting roughly four years, seems a reasonable, though far from certain, scenario.

The most serious risk to investors is a U.S. Treasury default, the likely end of the dollar's role as the global reserve currency, and a political deal that results in a draconian austerity program. As discussed in March, many noted economists have warned that "too large too soon" spending cuts may spill the economy into recession. Global investors have already begun to accommodate a new financial reality. The Chinese government has begun diversifying away from the dollar in earnest. The rise in gold is symptomatic of the need for an alternative store of globally priced riskless value. A diversified basket of major currencies, as Keynes suggested, is emerging as the appropriate alternative to the lack of a default free reserve currency.

Investors are rightfully wary of the risks ahead. Investors know that interest rates have to rise eventually. Fed policy will continue to be associated with underlying trends in the economy. The situation is little better internationally. Continued eurozone risks, inflationary pressures in China, and anemic GDP growth in Japan all indicate heavy headwinds for investors.

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## Research News and Announcements

A new paper, "Portfolio Monitoring in Theory and Practice," by Richard Michaud, David Esch, and Robert Michaud, has been accepted for publication in the *Journal Of Investment Management*. This paper presents a patent pending procedure for enhancing the Michaud rebalancing rule in use with the core portfolios that we manage. Even the most sophisticated institutional asset managers use ad hoc and theoretically unjustified methods for monitoring and trading portfolios. The consequences are ineffective costly trades or use of investment information. The new procedure extends the resampling methods New Frontier has pioneered and patented to further refine the monitoring and rebalancing process. Our investment process represents the forefront of asset management technology.

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Investor fears have given rise to interest in alternative strategies that promise safety from economic Armageddon and protection from "correlations going to one," "tail risk," and "black swans." But protection does not come cheap and often fails when most needed. Many alternative strategies that purport to protect in a market collapse contain the same derivative instruments that failed spectacularly in the Great Recession. For long-term investors, the fundamental precepts of modern finance remain valid: 1) the only sure way to reduce risk is to put less money at risk; 2) effective diversification (requiring advanced optimization technology) at an appropriate level of risk is the only free lunch in finance.

Recent experience confirms the fundamental importance of effective risk-appropriate globally diversified portfolios for meeting core investment objectives. An effectively diversified ETF 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.

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