The Sky is Falling, Rates are Rising!

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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.

Thoughtful long-term investors often invest in fixed stock/bond ratio asset allocations such as a 60/40 portfolio. Fixed target risk portfolios, typical of many sophisticated institutions, are often considered most reliable for meeting long-term investment objectives. Given recent news, some advisors and clients have been concerned about the possibility of rising interest rates and the impact of duration risk on their fixed income investments. How should an advisor address a client's concerns of a heating up economy scenario popular among many pundits?

Bond portfolio duration representing interest rate sensitivity can be managed a number of ways. The most obvious for reducing the duration of a portfolio is to reduce the allocation to medium- and long-term government bonds, and shift assets into corporates, municipals, and real assets such as real estate trusts. But it is important to consider how the portfolio itself as a whole is affected in any given scenario. As Harry Markowitz noted in his 1959 classic on scientific asset management, "portfolio analysis," not "security analysis" is of the greatest importance for managing risk.

In a scenario of rising rates, how the economy will function is a key issue. Impact on the portfolio depends on the nature of the adjustment of fixed income security prices to reflect a growing economy. Rising rates may, for example, indicate increased demand for capital. In that case, there may be little reason to make significant changes in the fixed income portion of a 60/40 portfolio. In this interest rate scenario, the 60% of stocks within the portfolio may also perform well, and the interaction with components of risk in the bond portfolio may evolve in a number of ways and ultimately have limited impact on the portfolio as a whole.

New Frontier does not directionally forecast interest rates. We let our technology do the work for constructing optimality. Our patented Michaud portfolio optimization technology constructs optimal portfolios and considers thousands of possible market scenarios, including a fundamental shift in how securities may be priced in many alternative economic scenarios, including a multitude of rising rate environments. Our optimization process uniquely accounts for uncertainty in capital markets and estimation error in the optimized portfolio.

There are always reasons to believe that bumpy roads may lie ahead. Pundits are paid to have an opinion that often changes daily. Such considerations are often best ignored for long-term investors. To the extent such considerations are substantive they are typically included in our investment committee deliberations where we assess markets, current information, and newly available research to incorporate into the portfolio analysis.

Our objective is to construct reliable long-term portfolios that are also short-term efficient. This does not mean that a concern that some aspect of global systematic risk may change is frivolous but that a portfolio tilt based on one possible future scenario is often highly unproductive and risky.

Since 2004, trusted advisors have hired New Frontier to give their clients the highest chance of investment success given uncertainty exists in the markets. Through independent research we formulate technologies to construct and manage optimally balanced portfolios allowing advisors to invest more time serving clients through planning and advice.

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