



Dr. Richard O. Michaud
President and CEO
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 four U.S. patents and is the author of *Efficient Asset Management* and many professional and academic articles.

A Greek Play

Markets

The second quarter of 2015 experienced heightened bond market volatility in anticipation of the Fed's first rate increase as well as international equity volatility involving Greek debt and Chinese equities. Despite whipsawed volatility, the major domestic and international equity indices ended close to where they started. The Dow was down 0.9%, the S&P down 0.2%, and the NASDAQ up 1.8%. Internationally, the ACWI was also nearly flat for the quarter. European equities were down 0.3%, Pacific equities increased 0.9%, and emerging equities were up 0.3%. Small caps were generally good performers. Chinese equities experienced high volatility depending on share class and exchange. The Chinese ETF in New Frontier's portfolios rose 5.8% for the quarter. The dollar was mixed against developed market currencies, falling 0.5% against the euro and gaining 2.2% against the yen. Rising long term rates led to a 9.5% decline in Long Treasuries. Duration also contributed to a 1.8% decline in the Barclays Aggregate Total Return index and a 10% decline in domestic REITs. Gold fell 1.4% for the quarter, and oil prices rose 15%. US equities saw less volatility than international equity counterparts; the VIX ended the quarter at 18.2 while VSTOXX was over 31%. The good news for New Frontier investors was that year-to-date our equity and growth strategies outperformed both the S&P and ACWI indices while the remainder outperformed on a risk-adjusted basis.

Perspectives

The dominant investment issue of the quarter has been the uncertainty caused by the imminent Greek government default on IMF bond payments scheduled for the end of June, and more generally, implications for the eurozone as well as global capital markets. As of this writing, the Greek government has defaulted. This is not the first time Greece has defaulted on bond payments nor is it the first time a sovereign nation has defaulted to its creditors.

Argentina is often used as an example of a similar economy when considering the consequences of a Greek exit from the eurozone. More than half of all Argentines lived in poverty in 2003. Inflation and unemployment rose sharply. But unlike Greece, Argentina was not part of a currency union. The Greek case is unique and much worse because Greece may be forced to leave the eurozone and return to the drachma. Furthermore, Greece is geopolitically significant given its NATO membership and its proximity to the Middle East. The possibility of a country leaving the eurozone also raises serious issues on the long-term viability of the euro and eurozone hegemony.

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.

The referendum announced by the Greek government for deciding whether to accept credit extensions in return for further austerity measures did not play well with European leaders. Negotiations have terminated until it is known whether the government will survive. The current Greek government has few friends left in the European Union. While a Greek exit from the euro has unknown consequences, the eurozone has instituted many reforms and the economic impact is likely to be manageable.

Domestically, the Federal Reserve remains concerned with the sustainability of the growth of the American economy and how long its policy of zero interest rates should be maintained. Currently, the U.S. economy seems to be in good shape, particularly relative to other major global economies. Job growth has been steady, GDP growth positive, inflation low, and unemployment continuing to decline. But wage growth remains relatively anemic. While a robust dollar is, in general, a positive sign of the health of an economy, it is a head wind for economic competitiveness internationally and a reason for anemic returns in equity markets in dollar terms. Given the uncertainty in the European economy and current economic indicators, the Federal Reserve remains wary of the risks associated with a change in interest rate policy.

Another major global concern is the state of Chinese markets and economy. At this writing, Chinese equities are in a bear market. We have noted in earlier commentaries of the likelihood of a market bubble in equities and real estate. The economy is slowing and the negative impact of regulatory immaturity, poor economic planning, and unfettered leverage is resulting in a downward spiral of margin calls and over supply. Still, the Chinese economy is very rich and unlikely to implode, and new initiatives containing the rout are likely. For the moment, global investors need to be aware of the risks of investing in Chinese markets.

Look Ahead

Domestic Economy

The American economy is in relatively good shape but the Federal Reserve is in no hurry to raise rates. The strength of the dollar, limited evidence of wage growth, and flat capital markets may result in delay beyond 2015. Moreover, when the Fed begins to raise rates, they are likely to be very moderate. This is a patient and cautious Fed that may moderate duration risk for some time. However, U.S. Treasuries continue to be priced not only relative to changes in Fed policy but also as the reserve currency and global safe harbor investment of choice.

continued on page 3

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.

European Economy

The Greek economy, which is roughly half the size of the Massachusetts economy, is only marginally important not only relative to the global economy but to the eurozone as well. The European economy has shown positive signs of economic growth following Mario Draghi's dramatic announcement of essentially an unlimited bond-buying quantitative easing (QE) stimulus program beginning in March. The program has shown evidence of energizing stagnant eurozone economies and limiting a deflationary spiral. The Outright Monetary Transactions (OMT) program is a new approach that focuses on "two legs;" bond purchases and conditionality requiring governments to request the bond purchases—effectively being put in ownership of their own future. The effort is to defragment monetary policy with borrowing costs and country risks. The surprising strength of the euro is one measure of the confidence that investors have in the eurozone in spite of the Greek drama. A delay in raising rates by the Fed may also have contributed to the strength of the euro.

Some resolution of the Greek drama is likely to be reached soon. Either path taken by the referendum will likely lead to continued tragic consequences for the Greek people. The euro, for all its benefits, is a straitjacket for faltering economies that austerity has little effect at repair. In one way or another, Greece is likely to abandon the consequences of a eurozone economy. In the long-term, it is likely that both the eurozone and Greece will be better off with some version of an exit.

Vanguard Index Changes

Global ETF managers were surprised by the Vanguard June 2nd announcement that four of their major international equity index funds and ETFs will be redefined in the near future. ETFs involved include Vanguard Emerging Markets ETF (VWO), Vanguard Developed Markets ETF (VEA), Vanguard European Stock ETF (VGK), and Vanguard Pacific Stock ETF (VPL). Added small-cap exposure will start later this year. Emerging Markets will also add exposure to China A-shares while Developed Markets will add exposure to Canadian equities. New Frontier invests in all four of these Vanguard ETFs and is currently researching the impact of index changes on our global strategic portfolios. We expect to have further comment shortly.

Endowment Model

The Yale endowment model that largely abandoned investment in public equities and the classic stock/bond core framework has been under much recent criticism and reconsideration by many institutional investors. The CalPERS clampdown on investment fees was mirrored by a number of other institutions who were concerned about significant investment fees with limited, even underperforming investment results. In many cases a simple 60/40 index fund strategy has outperformed many hedge funds over the last six years. Recognition of the problem of choosing alternative strategies that will do well among many may often be beyond the expertise of even the largest institutional investors.

continued on page 4

Adding to the Yale strategy controversy is an important new article titled: “What Would Yale Do If It Were Taxable.”¹ For advisor clients, generally taxes are important. The article points out that the after-tax returns of many alternatives may not be competitive with more traditional strategic and less costly ETF-based asset allocation strategies. Advisors should take serious note of the implications of new research, as well as the actual experience of sophisticated institutional investors.

Factor Investing

A number of fund providers have introduced “smart beta” or “factor investing” ETF funds as proposed alternatives to traditional active mutual funds. A major issue for advisors is considering whether such investments and strategies are appropriate for their clients. Factor investing is nothing new. It has been part of the toolkit of institutional quantitative managers for decades. Factor ETFs may seem an attractive, transparent, and low cost alternative. However, claims of outperformance may have limitations. The definition of factors is not standardized, with implications for both performance and risk management.² Moreover, outperformance relative to indexes may be dubious given that back tests are often based on historical periods when such factors were not part of practice. In addition, recent evidence suggests that outperformance may be an artifact of the rebalancing period and may not be indicative of long-term investing performance.³

Geopolitical Concerns

Finally, any review of the current global economic climate requires mention of the many geopolitical risks that continue to dog international markets. The Middle East remains a cauldron of horrors and conflicts. Yemen, Syria, Iraq, Libya, and Tunisia head a list of deeply troubled areas. Washington’s political dysfunctionality continues in spite of landmark judgments by the Supreme Court. The wholesale hacking of U.S. federal databases attributed to the Chinese government has many serious implications. The potential for major disruptions of the global economy is never far.

1 P. Geddes, L. Goldberg, S. Bianchi, Forthcoming, Financial Analyst Journal.

2 See for example: Michaud, R., 1998. “Is Value Multidimensional? The Journal of Investing. Spring 1998; Michaud, R. 1996. Investment Styles, Market Anomalies, and Global Stock Selection, The Research Foundation of the Institute of Chartered Financial Analysts.

3 Hsu, J. 2014. “Value Investing: Smart Beta versus Style Indexes. Journal of Index Investing.

New Frontier Research

We are pleased to note that Robert Michaud, David Esch, and Richard Michaud were each invited to present at the 5th International IMS-FIPS Workshop at Rutgers University at the end of June. Dr. Richard Michaud presented "[Portfolio Monitoring in Theory and Practice](#)," Robert Michaud discussed "[Practical Limitations of the Fundamental Law](#)," and Dr. David Esch spoke on "Portfolio Optimization Under Uncertainty."

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