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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.

Central Bank Dominance

Markets

U.S. stock returns during the quarter were mixed due to a rising dollar against most currencies. The Dow was down 0.3%, the S&P up 0.4%, and NASDAQ up 3.5%. The economy continued to exhibit robust job growth with minimal inflation. From a global perspective, it was a good quarter to be internationally diversified. The ACWI ex US was up 3.2%, led by Pacific equities 6.8%, European equities up 2.9%, and emerging equities up 1.9%. A rising dollar impacted global returns. The dollar rose 12% against the euro and was flat against the yen. Gold rose 0.6% to start the year, and oil continued declining, down 13% for the quarter. The Barclays Aggregate Total Return index was up 1.5% for the quarter while International Treasuries were down 4%. Domestic and international REITs were solid performers with more than 4% total returns. The VIX ended the quarter at a modest 15.

For the quarter, all global strategic portfolios benefited from international diversification, exposure to credit and duration, and REIT allocations. Standard portfolios outperformed tax sensitive due to treasuries and corporates outperforming municipal equivalents. Higher risk portfolios benefited from domestic small cap outperforming large cap. All of New Frontier's portfolios were positive for the quarter with very attractive Sharpe ratios, and all outperformed the S&P in total returns.

Perspectives

For global investors, the most dramatic economic news of the quarter was the announcement by Mario Draghi, the President of the European Central Bank, of an unlimited bond-buying quantitative easing (QE) stimulus program beginning March 9th. The program is intended to energize stagnant eurozone economies and avoid a deflationary spiral. ECB QE commits to buying eurozone government bonds and other debt at a monthly rate of 60 billion euros. The new Outright Monetary Transactions (OMT) program represents a new approach by focusing on "two legs": bond purchases and conditionality. By forcing governments to request the bond purchases, they are effectively signing up for strict conditionality and are being put in "ownership" of their own future. Draghi's plan is an effort to de-fragmentize monetary policy in the eurozone and competing perceptions of borrowing costs and risks.

Markets responded positively to Draghi's optimism and proposals. Spreads over German bunds diminished, the value of the dollar surged, and shares in European

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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.

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financials and equity indices performed well.

The ECB's commitment to QE should not be underestimated. However, there are serious headwinds. Interest and inflation rates remain low or negative while the long-delayed stimulus program has allowed deflationary effects to fester and left deep scars by the debt crisis. Skepticism remains. Unlike in the U.S., monetary macroeconomic stimulus theory is likely to be far more difficult to implement reliably in the context of uncoordinated economies in various states of economic stagnation. With Greece and other small economies as a backdrop and ongoing geopolitical risks, asset purchases with political credit and fiscal risks have the potential to significantly limit or delay effectiveness. Yet, most would consider the Draghi plan as the only realistic hope of untying the economic Gordian knot of continued economic stagnation.

Domestically and globally, Federal Reserve economic policies continue to dominate economic growth and capital markets. Investors are currently trigger sensitive to the Federal Open Market Committee's comments on the state of the economy. In the March 18th FOMC meeting statement, the term "patient" was removed, signaling to many observers that the committee could be raising interest rates by June for the first time in nine years. The announcement sparked a surge in the Dow, ending up over 200 points. A rate hike would be the Fed's biggest vote of confidence that the U.S. economy has recovered and that growth is sustainable. While it is far from certain that the Fed will raise rates in June, it is nevertheless indicative that the crisis in the American economy may have passed.

The Fed has reasons for a reasonably optimistic view of the American economy. These include U.S. unemployment at its lowest rate since 2008, GDP growth rate for the year at 2.4%, and modestly bullish Fed forecasts. However, headwinds have recently appeared, including a disappointing fourth quarter, GDP growth rate of 2.2%, down from 5% in the third quarter, the impact of a strong dollar on exports, weakness in the oil sector, some softness in job growth, persistent low inflation, bad weather in the Northeast, and uncertainty in global economies. For Chairman Yellen, wage growth, which has been nonexistent, continues to be a major concern. Overall, the Fed sounded optimistic about the economic outlook, but warned that interest rate hikes may be unlikely for some period.

While many economists would be surprised if the Fed does not raise the target range for the federal funds rate sometime in 2015, there is much uncertainty that anything definitive will happen anytime soon. Moreover, rate increases are likely to be very limited in 2015 and may be largely insignificant for the market.

While emerging market indices have been positive this quarter, the steep fall in oil prices and a strong dollar have had severe negative economic impacts on many

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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.

countries. This is because many funded current account deficits by borrowing overseas, often in dollars. Much foreign borrowing also occurred in the corporate and banking sectors. The continuing rise of the dollar and the prospect of more interest rate increases exposes much risk in emerging market sovereign, corporate, and banking sectors.

Japanese stocks have been stellar performers in recent times. The Bank of Japan has been effective in steering financial markets, pushing down interest rates, weakening the yen while fueling stocks to a fifteen year high. But, Japanese culture of rigid corporate and labor structure and obsessive savers is not easy to change. While the plunge in oil prices has been a factor, the core consumer-price index at 0% is far from the 2% target. Perhaps more importantly, GDP has grown at an annual rate of only 0.2%. Persistence and luck remain essential to Abe's ultimate success.

Chinese equity ETF returns were positive. But, the effort by the People's Bank of China to reduce controls on the economy has to contend with a strengthening dollar and a slowing economy. In addition, there are serious concerns about the effort to modernize financial markets, effective regulatory controls and enforcement, and rooting out corruption. Trading by nationals inexperienced with equity risk and limited investment alternatives raises continuing concerns about risks for U.S. investors.

Any review of the current global economic climate would be remiss without mention of the many geopolitical risks that continue to fester. The list of Middle East horrors and conflicts continues to grow at this writing. Complexities in the Middle East find the U.S. on the side of the Shiites in Iraq and on the side of Sunnis in Yemen while trying to neutralize Iran's potential for developing nuclear weaponry and continuing threats of religious terrorism domestically and abroad. There are also serious questions associated with Washington's political dysfunctionality with proposals in the new Congress to shut down the government and/or limit Federal Reserve borrowing. The potential for major disruptions of the global economy is never far.

Look Ahead

In its December announcement, The major central banks including the ECB, PBOC, and BOJ are implementing policies that weaken their currencies while the Fed is on the opposite path with a near term decision to raise short-term target rates. It is important to note that raising U.S. short-term rates may not have a negative effect on markets if the economy is seen to be growing robustly. Moreover, the policies of the central banks are theoretically aligned in that they all have the objective of managing private economies with modern monetary macroeconomic principles. But, all four major economies are in different stages of recovery and disruptions are nearly

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inevitable. However, a positive view is that central banks are all focused on managing growth and that significant investment opportunities may be available for thoughtful investors and managers.

One effect of U.S. central bank policies for investors is that strengthening the dollar will likely limit U.S. stock returns. This is a natural consequence associated with a likely increase in returns to U.S. investors through increased but diffused purchasing power. In a perfectly functioning global economy, the fall in the value of the U.S. dollar should be equal to the rise of a combination of equity and purchasing power returns. While American portfolios may not rise consistent with increases in economic growth, the ability to purchase goods and services may increase.

Media hype continues to latch on to “obvious” ways to make money. In a falling dollar scenario, the benefits of hedging dollar returns in international funds seem like a sure-fire way to enhance returns. As in many other similar cases, hindsight is a great way to invest. The sharp upwards bump in the recent decline of the euro demonstrates that simply using a future overlay of currency risk can be very risky. From a more institutional perspective, it may seem propitious to invest in international stock index hedged return ETFs. However, in finance, there is no free lunch. Michaud (1994) notes that hedged return strategies increase the correlations between securities and may significantly limit the value of diversification and risk management, all other things the same.¹

While the VIX remains at a modest 16, there are many reasons to anticipate near term volatility and emerging risks in U.S. and global capital markets. Inevitable fundamental changes in the relationship of global currencies will require sophisticated global recalibration of asset valuation. The national interests of major central bank policies are likely to result in conflicts not only from a geoeconomic perspective, but also geopolitically as well. Cultural issues may dominate macroeconomic theory in Japan and Europe and geopolitical issues for Chinese policy. Politicians may do much harm given limited understanding of macroeconomic theory or the political will for managing large economies effectively while attending to fragmented affinity group interests. In addition, it hardly needs saying that the Middle East is a cauldron of potentially devastating economic and political risks. Yet, as Churchill memorably said, “We usually make the right decisions after we have tried all the others.” effective investment technology is a necessary condition for active management success. This is the essential rationale for New Frontier’s continuing extensive research agenda in developing and refining Michaud optimization and Michaud-Esch rebalancing for asset management.

¹ Michaud, R. 1994. “Currency Hedging Policy.”
<https://www.newfrontieradvisors.com/Research/Articles/documents/currency-hedging-policy-100194.pdf>

New Frontier Research

We are pleased to note that Dr. Richard Michaud's upcoming presentation to the CFA Society of the UK in London at the end of April on "Portfolio Monitoring in Theory and Practice" (*Journal Of Investment Management*, Q4 2012), coauthored by Dr. David Esch and Robert Michaud, was fully booked more than a month in advance. Given interest, the CFA UK has now moved the presentation to a larger venue to accommodate more attendees. The CFA UK announcement is at <https://secure.cfauk.org/events/event-details.html?article=Mjl5MQ>. Richard Michaud's published and working papers are now available at www.ssrn.com and on www.researchgate.net. A new working paper by Richard Michaud, Robert Michaud, and David Esch entitled, "The Fundamental Law of Mismanagement," is also available for download. Robert Michaud presented the Dr. David Esch and Robert Michaud paper, "The False Promise of Target Date Funds" (*Journal of Indexes*, January/February, 2014) at fi360 INSIGHTS 2015, March 18-20, 2015.

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