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Nervous Investors, Choppy Markets

Markets

It was a choppy third quarter for global asset classes. Domestically, Large Cap equities rose slightly but Small Cap US stocks fell. The Dow rose 0.6%, the S&P rose 1.3%, and the NASDAQ rose 1.9%, but the Russell 2000 fell 7.7%. International equities, on average, fell for the quarter with the MSCI ACWI ex US down 6%. European equities declined 7.4% and Pacific equities fell 4.5%. Emerging markets fell by 4.3%, but China held a small 2% gain for the quarter. The Barclays Aggregate total return was flat. Lower than expected inflation numbers emerged and the Barclays TIPS Index declined 2%. Oil prices fell 12.2% for the quarter and Gold sold off down 7.5%. Domestic Real Estate's year to date run cooled, with REIT indices declining 2.5% for the quarter. International investing included currency winds. For the quarter, the Euro fell 7.8% against the dollar and the Yen dropped 7.6%. Volatility was on the rise as the VIX closed the quarter at 16.

Perspectives

A relatively uneventful eight months of modest but positive capital market returns and low average volatility ended in September with multiple days of choppy trading, sharp declines, and rising VIX levels. Investors seemed nervous and trigger sensitive to any hints of rising rates due to major indices at or near peak levels. A relatively sanguine interpretation of changes in sentiment may be due to being lulled into complacency with low levels of political and economic volatility and grinding but nearly automatic positive market returns for many months. Though the VIX fear index has risen significantly, it is still well within "normal" levels of stock market volatility. More substantively, additional issues included geopolitical events, such as conflicts in Ukraine and the Middle East, and sluggish international economies and markets.

Investor sentiments notwithstanding, there were important positive economic events during the month. Probably the most significant for domestic investors were announcements from the September meeting of the Federal Open Market Committee (FOMC). The Federal Reserve left interest rates unchanged while noting that the taper or bond purchasing program was ending in October. The committee promised to keep rates low for a "considerable time." With a focus on the long-term unemployed, Chairman Yellen was steadfast in waiting for signs of improved economic health before any serious changes in policy. The planned course for managing the bond buying program included letting holdings gradually shrink by allowing the bonds to mature when rates rise. The Fed's view of the economy remained optimistic, though guarded.

The Bureau of Economic Analysis' third revised report of GDP growth for the second

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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.

quarter of 2014 was a robust 4.6%. This is in contrast to the negative 2.1% estimated for the first quarter. Most economists consider the decline in the first quarter due to a number of one-off factors that do not meaningfully reflect a change in the overall strength of the recovery. While the FOMC and many economists revised slightly downward their forecast of GDP growth in 2015, inflation expectations of 2% or less were little changed.

One consequence of the Fed's carefully targeted pump priming economic stimulus program is a rebound of the dollar and a consensus that it is the reserve currency of choice. Generally, a stronger dollar is a positive for U.S. capital markets. More importantly, the Fed's programs for reducing unemployment from more than 10% to less than 6% have been an astonishing achievement.

In contrast, the economic news in the eurozone has been far from encouraging. Consumer price inflation rose by just 0.3% and was well below the European Central Bank's (ECB) 2% target rate. It is the lowest level for eurozone inflation since October 2009 and added to the fears of a deflationary spiral. Earlier this month, the ECB cut its benchmark interest rate to 0.05%. The long-term interest rates for many eurozone countries are well below the U.S. and are symptomatic of shrinking economies.

President Mario Draghi of the ECB initiated a bond buying targeted long-term refinancing operations (TLTROs) program of four hundred billion euros of four year loans at 0.15%. This offer of virtually free money for a four year term was amazingly only half subscribed, indicating the depth of eurozone economic stagnation. All signs are that the ECB will need to be even more aggressive with a quantitative easing (QE) program similar to the Fed. The ECB must inflate the eurozone balance sheet and depreciate the euro in order to fend off chronic stagnation or worse.

There are fresh worries about the pace and sustainability of Chinese economic growth. One recent indication was the People's Bank of China's (PBC) infusion of \$81 billion into the banking system to avoid a credit crunch. The housing sector has serious issues. China's war on corruption has had the curious effect of a decline in overseas deal making. More recently, the Democratic student protests in Hong Kong are a serious challenge to the Chinese central government's control over the island.

Small cap stocks have tumbled due to their greater sensitivity to rising rates and greater international exposure. Similarly, emerging markets have been negatively affected due to rising rates as capital returns to the U.S. The International Monetary Fund (IMF) forecasted decreased global growth due in part to eurozone uncertainties with Russia. On the other hand, Scotland did not vote to secede, a positive for the UK.

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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.

Look Ahead

Investors are properly concerned with investing in fixed income securities given the anticipated rise in interest rates sometime in 2015. However, it is important to understand that rising rates do not necessarily imply negative returns in a well-managed diversified portfolio over normal investment horizons. This is because roll-over return and careful management of duration risk including floating rate and short-term instruments can, and should, provide profitable results. Moreover, over the long term, a growing economy and demand for capital is likely to be the more dominant factor in driving returns.

The CalPERS announcement that it has given up on investing in hedge funds has stirred wide controversy. While their statement focused on high fees and complexity, their action resulted in a great deal of reconsideration of alternative investing in general. The announcement is significant not only because CalPERS is seen as an international thought leader in endowment and foundation investing but also because it was one of the originators of the strategy for major institutions. Other entities, including the SEC and the London Pension Funds Authority, have fallen suit in criticizing hedge fund investing. An interesting parallel narrative has emerged questioning whether hedge fund managers are highly sophisticated or simply overly leveraged and whether standard asset allocation frameworks with far less complexity and much lower fees are no less desirable.

An important developing issue includes recent revelations of the Federal Reserve Bank of New York's regulatory relationship with many large New York investment banks. The Beim report and the Carmen Segarra tapes raise real concerns of possible serious conflicts and important failures in the U.S. regulatory process that may have had a major effect in the meltdown of 2008/9.

Other investment concerns include Russian and Chinese cyber terrorism perilously undermining the confidence and functioning of digital commerce. Recent identification of the Shellshock virus deep in basic Linux and UNIX code and reports of massive cyberattacks on as many as ten sophisticated financial institutions including JPMorgan Chase are profoundly unsettling. Middle East religious terrorism is a scourge of human values with armed conflict consequences.

Prospects for eurozone and international equities remain guarded at best. Imminent midterm elections raise concerns on the future direction of U.S. fiscal and economic policies. Negative rates in some overnight-lending Treasuries and in the eurozone have serious implications for the stability of money market funds. How long interest rates will have to stay low in order to manage record debt levels is very uncertain. Recent rises of large cap while small cap indices decline demonstrates the limitations of single-factor strategies. These and other considerations underscore the value and

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importance of New Frontier's uniquely effective portfolio diversification and risk management technology. On a more positive note, the U.S. continues to be a primary source of global innovation. The recent process of reshoring U.S. based manufacturing is indicative of important changes in the global economy.

New Frontier Markowitz Video

We proudly remind our readers that an enhanced audio and captioned video of [Dr. Richard Michaud's interview with Nobel Prize winner Dr. Harry Markowitz](#) at the Spring 2011 JOIM conference, when the joint JOIM/New Frontier sponsored [Markowitz Awards](#) were inaugurated, is available on our website www.newfrontieradvisors.com. In the interview, Dr. Markowitz traces the evolution of his seminal work in modern finance, portfolio theory, rational behavior, computational methods, the great debate with Paul Samuelson, and his latest research.

Tenth Anniversary as an ETF Strategist

New Frontier is extremely pleased to note our tenth anniversary at the end of October as an ETF strategist. We are very grateful for the support of the executives and managers of the firms that work with us, as well as advisors and their clients who took a chance on the integrity and effectiveness of our technology in developing and managing taxable and tax-exempt GSAA strategies. We have evolved into not only one of the earliest pioneers in global ETF management but one of the most experienced in the world today. We simply want to thank all our friends and supporters for these many good years with all of you. We hope to continue to earn your trust and meet your expectations for the next ten years and more.

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