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

Calm After the Storm

Equity investing was a solid bet in the quarter. The Dow rose 8%, the S&P 500 13% and Nasdaq 19%. International equities also rebounded nicely from the prior quarter. Europe and Pacific indices were up roughly 11% while the Nikkei 225 posted a remarkable 19%. Bond indices were mixed with the Barclays Capital Aggregate Bond Index flat and long term Treasuries down 7%. Market volatility significantly diminished with the VIX at 16%. The dollar declined against the euro by 3% but was up 7% against the yen. Oil prices rose but performance varied between indices. WTI Cushing Spot price rose 4% for the quarter while the Brent Crude Oil Spot rose 14%.

Perspectives

The quarter was dominated by a substantial reduction in the uncertainty associated with the European sovereign debt crisis and the risk overhang affecting global capital markets. Greece managed to satisfy all of the European Union's (EU) demands for receiving bailout funds and the pressure of imminent default was averted. The low interest loan policies to European banks begun in mid-December by the newly elected President of the European Central Bank (ECB), Mario Draghi, in coordination with major central banks, averted a serious credit squeeze that would have greatly disrupted the eurozone and global economies.

The seemingly endless meetings among eurozone members were clearly focused on buying time until basic agreements were reached. While the likelihood of further Greek default remains high, the plan is to have firewalls in place so that contagion among eurozone members and disruption from possible exits in the euro will be minimized. Agreements for adding 500 billion euros to the rescue fund address many credible default contingencies. An important takeaway is that the 17 member eurozone appears to have reached a consensus of commitment to the common currency.

However, real risks remain. The Organization for Economic Cooperation and Development (OECD) recommended a firewall of twice the size in place, a trillion euros, to prevent possible runs against currently solvent sovereigns. The politically necessary austerity policy has the risk of continuing to encourage slow growth, unemployment, civil unrest, and recession. Indeed, many economists believe that Europe is already in recession, limiting the ability of even the largest eurozone economies to fund additional ailing members.

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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.

There is a positive side to the eurozone crisis that is worth noting. Imminent cataclysmic economic consequences can concentrate minds and create a political will that transcends party ideology and economic differences. Many European economies are afflicted by social immobility, perpetuation of social divisions, static societies, and closed economies. Radical proposals to restore competitiveness and equality of opportunity are being proposed and implemented. Portugal, Italy, Ireland, and Spain are in the process applying drastic budget cuts, reforming the labor market, and opening up their economies to global competition. Voters in Britain, Ireland, Portugal, and Spain have supported parties that promised painful realism. Italians and Greeks know well that the days of free-spending and tax-dodging are coming to an end. The era is reminiscent of the mid 1930s in the United States when the Roosevelt administration proposed, and congress passed, many novel programs and policies in an effort to get the American economy growing and putting people back to work. The European sovereign debt crisis could result in fundamental positive political, ideological, and economic change that will invigorate eurozone members in the future.

From the U.S. perspective, the easing of European default risk, the slow but sustained recovery of the American economy, and unemployment slowly healing led to a positive low volatility investing climate this quarter. The Federal Reserve forecasts holding interest rates low to encourage further economic growth and employment. Ben Bernanke's four lectures on the Fed's policies through the Great Recession noted that major risk factors are now better understood and are being addressed in proposals for improved regulation and increased capitalization standards.

However, the positive domestic news has a negative side. The fervor for fundamental change in the American economic and financial system has largely abated. The dramatic turnaround of equity markets since the March 9, 2009 lows has encouraged the view that substantial change may not be necessary. But unaddressed structural problems remain. The Dallas Fed's report on the risky bets banks made, the economic disruptions it caused, and the rewards they received is a reminder and indictment of continued weaknesses in the nation's current financial system. The report warns that a cartel of too-big-to-fail megabanks may be hindering the recovery with intensive lobbying efforts. Many of the largest banks are undercapitalized and host balance sheets cluttered with toxic assets. A number of banks are anticipating significant credit downgrades in the near future. In a sense, the stimulus packages and Bernanke-led Fed policies may have worked too well and may result in lost opportunities for repairing the problems in the nation's financial system and enhancing competitiveness of the American economy for the 21st century.

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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.

Look Ahead

The Fed has announced that it stands ready to promote economic growth with all the tools at its disposal. The Fed policy of low interest rates and cheap credit may still be needed to help the job market heal for some time to come. However, the inevitability of a rise in interest rates at a foreseeable point may encourage investors to avoid fixed income securities. This sensible conclusion is problematic. The financial reality is that markets clear and prices depend on buyers as well as sellers. Time horizons and global forces are always considerations. The importance of diversification is always prudent for long-term investors.

A related issue is the somewhat paradoxical resilience of the euro in the face of the eurozone sovereign debt crisis. An important explanatory factor in euro/dollar rates has to do with the Chinese government's ongoing policy of diversifying the currencies of their largely dollar denominated reserves. However, it is worth noting that the policy is having consequences in terms of rising bond yields and inflation in China.

The global economy's growth continues to depend on the slow expansion of the American economy. The key question is how realistic and robust is continued growth? U.S. stocks that seemed undervalued at the turn of the year may appear less so given the recent run up. China's economic growth is largely a reflection of its relationship to the American economy and unlikely to have much positive independent effect near term. Flare ups in the Middle East and additional rises in oil prices could significantly limit the expansion. A presidential election cycle and ongoing domestic political dysfunction are significant risk overhangs for the future of American markets and economy.

Reflections

Asset managers and advisors often propose a two fund asset allocation that consists of investing in individual equity and bond or non-equity funds. For example, a two fund asset allocation may consist of 60% invested in an all equity fund and the remainder in a bond fund. Theoretically, such a proposal is suboptimal. This is because the risk-return relationship of the strategy lies along a straight line connecting the two funds. In contrast, an effectively optimized asset allocation that includes all the assets results in a curved efficient frontier that lies above the straight risk-return line of the two fund strategy. Consequently, the two fund risk-return relationship is inferior to the optimized asset allocation at almost all levels of risk. The key assumption for the enhanced benefit of optimized asset allocations is the availability

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of investment effective optimization technology. Simple two fund asset allocations are not recommendable relative to effectively optimized alternatives.

Research News

The first public presentation of New Frontier's research and software technology on Portfolio Monitoring and Rebalancing was given by Dr. Richard Michaud in Hartford on March 6. The first public presentation of New Frontier's research on Deconstructing Black-Litterman will be given in Chicago, April 26, at the fi360 conference by Richard Michaud. The Richard Michaud interview of Dr. Harry Markowitz published in the *Journal Of Investment Management* is recommended to all students of modern finance and available as a free download at our website: www.newfrontieradvisors.com.

April 5, 2012