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Navigating the Financial Crisis

The quarter has been one of many extremes. From an investment perspective, January and February continued the grim downward spiral of returns from the previous quarter in almost every major asset class, followed by a surprisingly good March. From an economic perspective the real economy continued to deteriorate. Unemployment and mortgage foreclosures climbed at an alarming rate. The Obama administration had to contend with a number of momentous financial and economic concerns even in its first few days in office. The continuous drip of bad news contributed to a growing sense of the magnitude of the financial crisis and its implications for the real economy resulting in a sense of fear that gripped consumer and investor alike.

The Treasury and Federal Reserve have managed the crisis innovatively and aggressively. As the quarter ends, there is a growing economic consensus that the stimulus, funding and intervention programs are on the right track. In a remarkable three hour interview on CNBC on March 9th, Warren Buffett strongly endorsed the Obama administration's efforts to contain the financial crisis. He compared the importance of the Treasury and Fed programs to the economic equivalent of going to war after Pearl Harbor. He also noted that banks should now be profitable in this climate of cheap money. The following day, Citi and Bank of America reported they had been profitable in the first two months of the year. Also, the government reported that housing prices jumped 1.7% in January after many months of declines. Perhaps coincidentally, the Dow has risen 20% since the Buffett interview, satisfying the traditional definition of the start of a bull market.

Despite these positive signs, the financial crisis has had a devastating negative impact on the real economy. The IMF predicts that the global economy will shrink as much as 3% this year, the worst performance in most of our lifetimes. Economic contraction in many parts of the world is likely to be very severe and cause much human suffering. The American and global economies are likely to be in recession throughout the year and possibly beyond.

The world's financial system has gone through its greatest crisis for at least a half century. If nothing else, the crisis has demonstrated that efficient functioning of capital markets requires thoughtful and effective regulation. Misused innovations such as securitization and leveraged derivative strategies spread toxic assets across the globe. Increased and more effective regulations are part of the future of world finance. Recommendations will include increased reserves of capital against trading activities, maximum gross leverage ratios, enhanced supervision of rating agencies, and centralized clearance of the majority of trades in credit default swaps and other derivative strategies. Large scale proprietary trading through in-house hedge funds is likely to be limited. One critique of enhanced regulation is that financial institutions are going to be less profitable. However, the lesson of AIG is that many of the

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About New Frontier

New Frontier is a Boston-based institutional research and investment advisory firm with an extensive background in quantitative research, consulting, and management.

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 cutting-edge practical economic theory, New Frontier's services help institutional investors, across the globe, to select and maintain more effective 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.

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profits from leveraged strategies may turn out to be illusory and extremely dangerous for the normal functioning of capital markets and devastating for the real economy.

While the consensus of major economists has been largely very positive for most of the proposals of the Treasury and Federal Reserve, one has come under particular criticism. The Term Asset-Backed Securities Lending Facility (TALF) has been critiqued by a number of notable economists including Paul Krugman and Joseph Stiglitz. In an op-ed piece in the New York Times (April 1, 2009), Stiglitz likened the program to a highly leveraged call option on taxpayer revenue for the benefit of participating institutions. Such critiques serve to warn the administration that the TALF may have very serious flaws and may need to be very carefully managed, altered, or abandoned for more direct intervention.

In spite of important open issues such as potential bankruptcies for GM and Chrysler, the domestic economy seems to be weathering the crisis relatively better than its counterparts. One reason is that the American government has been much more aggressive at managing the crisis than its European or Asian counterparts. The Fed's announcement that it would "employ all available tools to promote economic recovery and to preserve price stability" serves to highlight the point. In addition, U.S. banks are quicker to write down their problem assets, U.S. corporations have more liquidity and relatively little debt, and the U.S. has faster population growth and less cultural rigidity.

What should investors be thinking today? Investors should be wary of the potential impact of persistent higher volatility on meeting long-term objectives and the need to be more realistic in investment expectations going forward. The VIX remains at levels of volatility indicative of depression era risk. Current risk levels are far greater than those experienced in time periods of studies that are the basis of much of our understanding of long-term investing. Persistent high volatility is likely to limit the ability of investors to meet many of their long term objectives. In addition, more normal functioning capital markets, limited leverage, and reduced consumer activity imply that equities are unlikely to go back to levels at the height of the bubble anytime soon.

From a structural perspective, Michaud (1981)¹ provided a formula for estimating the maximum expected sustainable long-term growth available in capital markets. Long-term investing requires realistic understanding of the fundamental limitations of capital markets. Attempts to overcome these limitations, as observed in recent times, may often be unproductive and self-defeating. The time-tested fundamental principles of effective long-term investing include transparent funds, strategic global diversification and risk management, low cost quality investments, and innovative investment technology.

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¹ Michaud, R. 1981. "Risk Policy and Long-Term Investment." *Journal of Financial and Quantitative Analysis* 16(2):147-167.