Robert Michaud
Chief Investment Officer

Robert Michaud is the co-holder of four U.S. patents in portfolio optimization and asset management and is the Chief Investment Officer at New Frontier. He holds a Masters in Mathematics from Boston University and pursued a PhD in finance from the Anderson School of Management at the University of California at Los Angeles before joining New Frontier. His research interests include risk models, empirical asset pricing, and international finance. He is the co-author of Efficient Asset Management: A Practical Guide to Stock Portfolio Optimization and Asset Allocation, (2nd ed. Oxford University Press, 2008) and research articles in refereed journals.

Q3 2024: Shifting Tides: Broad-Based Optimism Fuels Market Momentum

Markets changed character to broad-based optimism relating to the economy. The economic picture began to come into focus with inflation continuing to moderate as the economy maintains steady growth and employment. The result was a stark turnaround for economically integrated or interest rate sensitive assets, which resulted in a great quarter for diversified multi-asset portfolios. New Frontier sets a major milestone in Q4, marking 20 years of investing at the end of October.

Market Performance

The stock market continued its upward momentum in the third quarter, reaching all-time highs despite some turbulence. Though economic indicators remain overall strong, concerns over a slowing economy and cooling labor market triggered swings in sentiment and two brief market dips. As markets readjusted expectations, the long-anticipated Federal Reserve's first rate cut of 50 basis points and its shift toward a more neutral policy stance to balance inflation and employment risks helped bolster confidence. The MSCI ACWI IMI index rose 6.8%, and the S&P 500 gained 5.8%.

Unlike the first half of the year, when U.S. big tech companies dominated, U.S. equity returns broadened to other market segments during the quarter. Value stocks, small-caps, dividend stocks, and real estate outperformed the market. As a result, well-diversified multi-asset portfolios performed exceptionally well this quarter.

Geographically, international equities outperformed U.S. markets. Chinese stocks gained 20% in one week following aggressive measures to support property and equity markets. This surge erased the previous six months' losses and boosted Emerging Markets, up 7.3%. The Asia-Pacific market rose 8.8%, partly helped by Hong Kong shares, while Japanese equities remained volatile with mixed economic data. European equities gained 7%.

Bonds also had a strong quarter, although for different reasons than stocks, as interest rates fell broadly and inflation cooled. U.S. aggregate bonds rose by 5.3%. The 10-year Treasury yield ended at 3.81%, down 55 basis points from Q2. As inflation eased, bonds, especially long-term Treasury bonds, regained a negative correlation with equities, providing a valuable risk hedge for diversified portfolios. Long-term Treasury bonds were among the top performers, with a 7.8% gain this quarter. Credit spreads narrowed marginally, with investment-grade and high-yield bonds gaining 6.6% and 5.5%, respectively. International bonds additionally benefited from a weakening

dollar, rising 9.5%.

Strategy Performance

New Frontier's ETF portfolios delivered impressive returns across the board this quarter, with both bond and equity allocations driving absolute returns and relative performance.

All holdings had positive quarter returns, and effective diversification greatly benefited the portfolio. For **Global Core**, allocations to REITs, Gold, Low Volatility equities, as well as long-term and international bonds, contributed to outstanding relative performance. Furthermore, the portfolios' underweight in the U.S. large-cap growth stocks and overweight in small-cap stocks enhanced relative performance.
Tax-Sensitive portfolios largely mirrored the performance of Global Core, albeit with slightly lower returns as municipal bonds trailed taxable bonds.

Our Multi-Asset Income (MAI) portfolios had a comeback quarter, with dividend stocks outperforming the broader market. Our selection of U.S. and Developed Market high-dividend ETFs achieved impressive double-digit returns. Allocations to REITs, small-cap dividends, long-term and Emerging Markets bonds further enhanced relative portfolio performance. Currently, MAI portfolios offer attractive yields ranging from 4.5% to 5%.

20 Years of optimized ETF portfolios

New Frontier Global and Tax-Sensitive strategies were launched on October 29, 2004. 20 years ago ETFs were considered a niche asset, limited in quantity and function — the 157 available ETFs at the time generally tracked a simple cap or float-weighted index. Over the course of 20 years, ETFs have become the accepted building blocks of sophisticated portfolios, with over 3,000 U.S. listed ETFs with a wide range of purpose and structure today. It's been a major journey to get where we are, and our portfolios have gained sophistication along with the ETF market.

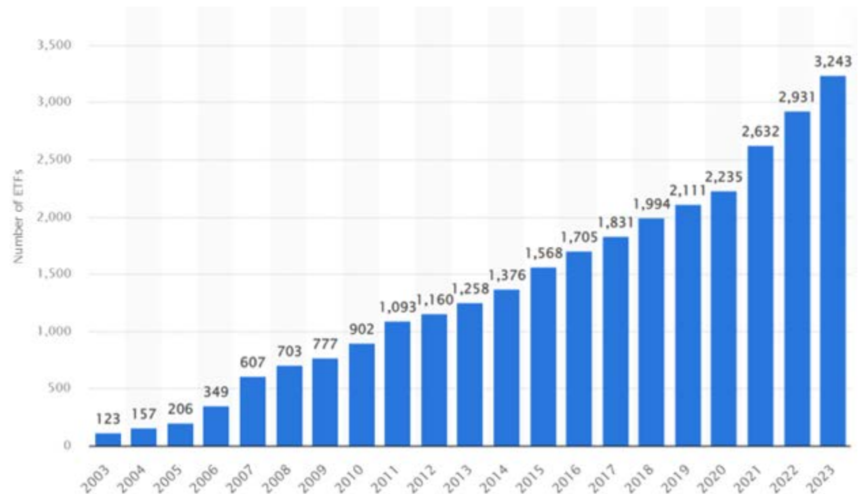
About New Frontier

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 newfrontieradvisors.com

New Frontier Portfolios

New Frontier develops and manages a broad range of ETF asset allocation portfolios for advisors and their clients, and currently oversees over $5 billion in ETF asset allocation portfolios.



Source: Statista

Private vs Public investments

In spite of the explosion of active ETFs and ETFs representing more sophisticated asset classes, not all asset classes are well represented by ETFs. The most obvious difference between New Frontier portfolios and portfolios typical of large institutions is the allocation to private assets. Private equity, and more recently, private debt are popular among certain institutional investors hoping for higher returns from illiquid assets managed by top quantile managers. However, much of the purported outperformance of these asset classes comes with more than commensurate amounts of risk. Private equity has returned little more than public stock markets, and private debt has far more exposure to economic downturns than traditional fixed income asset classes. While top managers have performed well, even the most sophisticated institutions struggle with manager selection and the high fees paid to these managers do not guarantee good performance—below average managers have grossly underperformed public markets. Risk of manager selection remains a serious issue for would-be investors in private markets—bottom quartile managers underperform the average by 6.6% for private equity and 2.8% for private debt.*

*Source: A year of disruption in the private markets: McKinsey Global Private Markets Review 2021

Model Positioning

How to invest in fixed income amid falling rates: Bills vs Notes

What fixed income securities should an investor hold in a falling rate environment? Treasury bills are short-term securities with maturities up to 52 weeks. Treasury notes have maturities starting at 2 years (up to 10). A common misconception is that investors will necessarily be better off locking in high rates now rather than staying in floating-rate securities that are expected to gradually provide lower rates of income as interest rates decline.

The misconception comes from focusing on return rather than risk. Short term notes will be priced to closely match the markets expected yield from bills through arbitrage mechanisms. Therefore, at every point in time, investors should expect to be equally well rewarded either investing in a short term note, or by rolling investments in a series of bills. The difference is risk. For some investors the extremely low volatility of principle makes bills more desirable, and others will prefer knowing the precise income for the length of the note.

Similarly, shifting from short-term to longer-term bonds after markets have already priced in future rate cuts may not be beneficial and can even backfire if market expectations prove overdone, as seen in recent weeks. Predicting the direction and timing of rate shifts is extremely difficult.

It's wise to consider bond allocation in the context of total portfolio construction, as each type of bond has distinct risk and return characteristics. Floating-rate or short-term bonds remain attractive as low-risk components, with yields still at elevated levels. Long-term Treasury bonds are once again serving as a hedge against equity risk as inflation cools, while they still carry significant interest rate risk relative to their yield. Despite tight credit spreads, credit bonds offer solid yield opportunities, particularly in a plausible soft-landing scenario.

Model Changes

New Frontier uses Intelligent RebalancingTM, the Michaud-Esch portfolio rebalance test, to guide portfolio reallocation and rebalancing decisions. This framework allows us to simultaneously consider changes to the risk characteristics of portfolios from price movements, and changes to optimal portfolio exposures from new capital market expectations.

No models were rebalanced this quarter due to the broad positive performance from all ETFs in each portfolio. Portfolio fixed income exposures continue to be monitored and optimally positioned for anticipated future interest rate cuts. Likewise, other asset classes continue to represent a balanced exposure to equity risk factors and asset classes. Given the high certainty of lower rates in the future, current portfolios were further tested against portfolios optimized using risk and return expectations based on risk and return expectations conservatively adjusted for these anticipated rates. For example, these portfolios would naturally rely less on ultra-short duration fixed income for superior return. Continued monitoring against these assumptions will ensure continued statistical optimality of our portfolios with respect to the duration of fixed income and balance among all asset classes.

Asset Class insights

Last quarter, we discussed inflection points for asset classes that have performed persistently outside expectations in the past. Here's what happened to certain asset classes that contributed to performance last quarter:

Small cap stocks were buoyed by lower rates and positive sentiment this quarter. The bigger question is whether they will continue to perform well going forward. Small companies theoretically have a higher cost of capital due to greater risk and lesser access, which should reward investors, on average, who demand higher rates of return in exchange. However, these rewards should be smaller than in the past since the issues have lessened: risk is lower due to superior information; trading costs and liquidity have improved; and broad baskets of stocks are cheaply available to investors.

Large growth stocks (i.e. U.S. big tech) were the lowest return asset class last quarter. While still concentrated and volatile, investment in AI, and hence return potential, has not subsided (as seen by the recent recapitalization of OpenAI). Further demand from international investors will continue to focus on U.S. tech companies as it remains the nexus of talent, research, and hardware.

Value, Dividend and other non-Mag-7 stocks also performed well. There's more to the U.S. economy than just technology—consistent economic growth along with investor-friendly regulations and corporate culture continue to bode well for these asset classes long term.

International Stocks performed well in absolute terms and outperformed the U.S., which was held back by the underperformance of big tech stocks.

REITS were a top performer last quarter as rates finally began to fall. REITs suffered from the double surprise of the pandemic, first through lower demand for office space, then through higher borrowing costs for the interest rate sensitive assets. Our investment thesis was that real estate remained a viable asset class after those initial shocks, however REITs suffered further as central banks were slower than anticipated to lower rates in light of persistent inflation. REITs should return to more favorable risk and return characteristics going forward.

Emerging markets performed well thanks to the remarkable contribution of China. Going forward, emerging markets represent diverse and growing economies making them valuable in a portfolio.

Gold, unlike crypto assets, has done well as a risk management asset.

ETF watch:

- **Ethereum** ETFs were successfully launched. Given the complexity of the underlying asset, the ETFs have been highly successful at providing a highly liquid and low expense ratio investment option for those seeking exposure. However, given the high volatility and basic uncertainty about its risk and return characteristics, we do not consider it an investible asset in a portfolio. Despite its success as an ETF, etherium has not appreciated from the increased activity and investment.
- **Private credit** ETFs are coming. As perhaps the trendiest institutional asset class, there will be pressure and confusion as to how, or whether, to use it in a portfolio.
- U.S. listed ETFs recently passed $10 trillion in assets. This compares to the roughly $100 trillion market value of all U.S. listed stocks and bonds.

Other insights:

- **Mag-7** stocks affect the volatility of even global multi-asset portfolios due to their high volatility and large weights in the global market portfolio. The seven largest tech companies have approximately the same weight as the seven largest countries outside the U.S. (Japan, UK, Canada, France, Switzerland, China, Germany), but with much higher risk.
- **Debt continues to climb** but so far has not increased volatility of bond markets. Taking on debt can be a powerful resource [for stimulating an economy in the right circumstances], but if fiscal policies to manage the economy are not successful, cumulating debt becomes an economic burden.

Implications of Market Highs

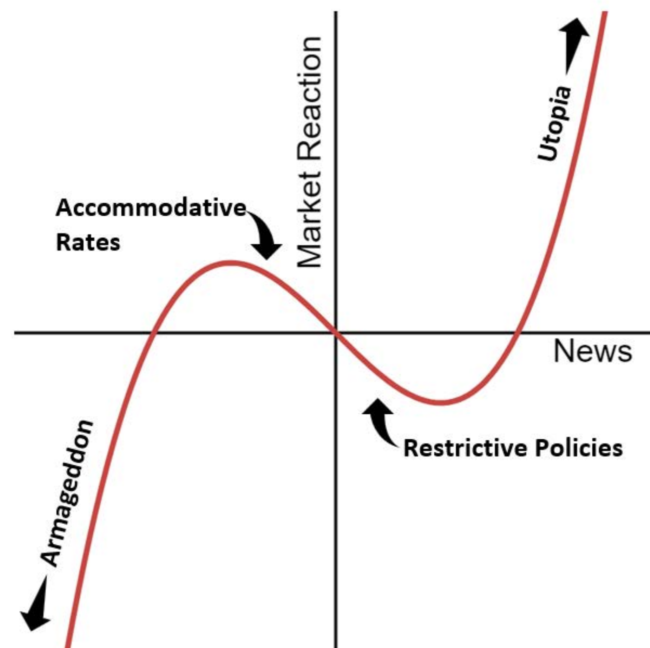
All New Frontier indices (all strategies and risk levels) achieved all-time highs during and at the end of the quarter**. From history, we know that market highs are not a reason to change investment plans, as forward returns tend to be at least as positive when starting from a market high as otherwise, as we discussed in What Goes Up Might Not Come Down.

**Source: indices calculated by S&P Dow Jones Indices

The Economy

Is good news good?

Markets have at least partially transitioned from being hyper-focused on interest rates. However, markets sometimes decline, seemingly paradoxically, on unanticipated positive news. To understand this, consider that prices generally reflect the expected future value of the asset discounted into today's dollars. Typically, good (bad) news means expectations of future value are higher (lower), so the market should go up (down) – and when the news is significant enough, that almost certainly happens. However, when the news impacts monetary policy, a modest effect on future growth and earnings of companies may be more than offset by the immediate impact on policy. This is illustrated below where policy reaction has the greatest influence when the news is small, and good news is bad, but major economic changes eventually dominate so very good news is very good.



Source: New Frontier

Fed Watch

The Fed finally lowered rates by 50 basis points in September. The Fed indicated that the large change was due to catching up on economic data that had not been available at the previous meeting, rather than an indication of urgency. Still, markets had expected more rate cuts sooner than the Fed had indicated. However, stronger economic news following September's Fed meeting rapidly changed market expectations. Below, we see the implied market interest rate expectations before (blue line) and after (green line) the September Fed meeting. The latest market expectations have pared down deep cuts, aligning more closely with the Fed's guidance for 2025.

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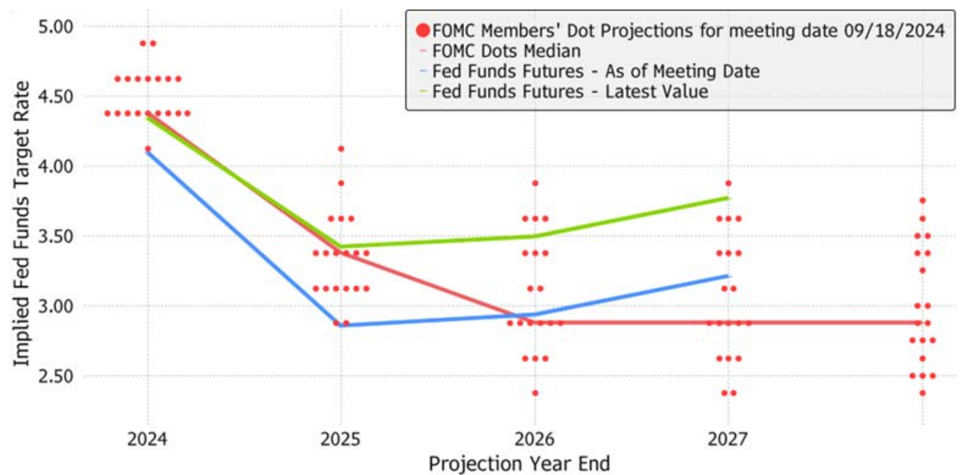
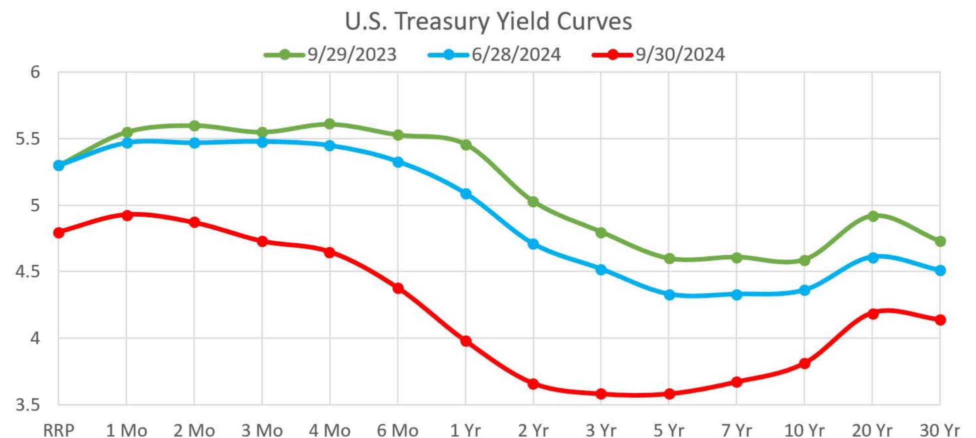


Source: Bloomberg

The Fed and Rates

Compared to quarters in the past, rates fell dramatically. This quarter marked the tipping point for the evidence of falling inflation to enable Fed rate cuts to begin.

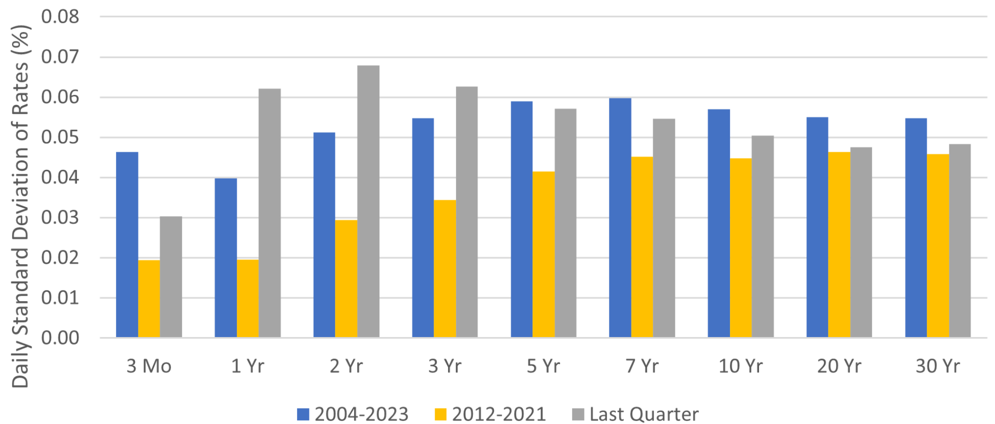


Source: U.S. Department of The Treasury

Comparing the yield curve at the end of the third quarter (red) to either the second quarter (blue) or previous year (green), we see major decreases across all maturities. From basic principles, it's surprising that rates as far as 30 years into the future were impacted by a change to the Fed funds rate—a short term rate that will change in both directions many times in the future. The butterfly effect may explain the volatility of long term forecast since small actions or changes can have unpredictable effects and consequences in an ecosystem as complex as the financial markets.

Fixed Income Volatility

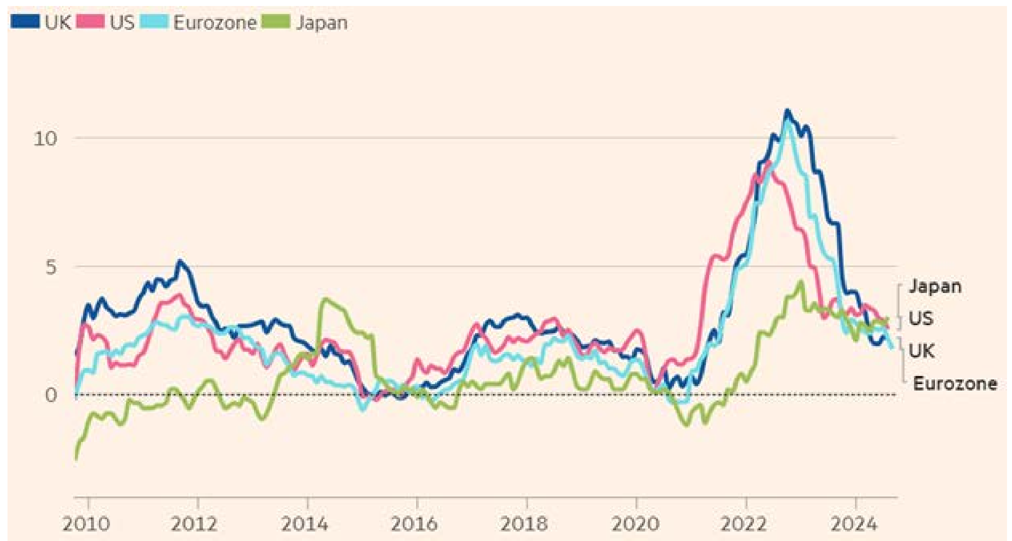
Currently, short-term (1-3 year) interest rate volatility is somewhat elevated, but most is typical of a changing rate environment. The volatility is indicative of the risk of making the wrong decision when trying to lock in rates over the next few years. In contrast, five to thirty-year rates have similar or lower volatility compared to longer-term observations over 2004-2023. All rates remain more volatile than they were in the calm decade before the Fed began raising rates (2012-2021).



Source: U.S. Department of the Treasury

Inflation

Concern that inflation will plateau before sustainably reaching target levels of 2% remains, due to continued robust economic indicators. With U.S. inflation rates falling to 2.4%, inflation rates in major developed markets are now generally below 3 percent and still trending downward. While this offers little consolation to consumers suffering from reduced purchasing power over the last three years, it is good news for the Federal Reserve. The Fed can now balance economic growth and inflation through deliberate interest rate cuts. However, these cuts may be implemented more slowly than the market is hoping for, as the Fed carefully monitors economic conditions.



Source: Financial Times. Annual Percent change in CPI as of 09/2024 for US and Eurozone, Japan and UK as of 08/24.

Conclusions

Last quarter, the market began adjusting to a lower rate future. Inflation remains plausibly on target and though the risk of economic slowdown should never be ignored, most economic indicators remain fairly strong. For most investors, there's no rush to change fixed income holdings due to the change in rates, provided they have a sensible allocation based on current conditions. Over time, allocations will change as longer maturities offer clear advantages in the form of higher rates.

Technology progress and AI is not going away, but it's beneficial for the market to change focus and assess the value of other assets from other perspectives. Whether the current generation of AI technology revolutionizes the economy or remains an improved internet search and research tool remains to be seen. Quite likely it will fall somewhere in the middle, with substantial productivity gains gradually reaching much of the economy. With technology as with investing, it's necessary to stay informed and adapt.

To learn more about New Frontier's risk-return efficient portfolios, and how our investment process enables our portfolios to adapt to shifting and evolving markets, contact us at 617-482-1433, or at nfglobal@newfrontieradvisors.com.

DISCLOSURES: Past performance does not guarantee future results. As market conditions fluctuate, the investment return and principal value of any investment will change. Diversification may not protect against market risk. There are risks involved with investing, including possible loss of principal.