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The Stealth Economy

Performance for the month, quarter and year confounded many forecasters. While fears of the sovereign debt crisis, secular bear markets, high unemployment, and a double-dip recession spooked and whipsawed undiversified investors, the market climbed a wall of worry. September posted some of the best monthly performance for equities in over seventy years. The Dow was up 8%, the S&P 9% and the NASDAQ 12%. The quarter turned in a stellar performance as well with the Dow up 10%, the S&P 11% and the NASDAQ 12%. For the year most capital asset indices turned positive with the Dow, S&P and NASDAQ up 4%. While the Lehman Aggregate rose 8% and outperformed many diversified equity indices for the year, the third quarter found a return to a more normal risk-return relationship between fixed income and equities.

There were surprising gains in almost all asset classes. In a period of great uncertainty, growth beat value, Europe beat Pacific, small largely beat large cap, and REITs were stellar performers. While much attention was focused on commodities and currency uncertainty, gold was a relatively modest performer. Fear proselytizers and pundits were proven wrong. Well diversified global strategic portfolios avoided whipsawing while being a moderating influence in earlier volatility. Though investors pulled money out of mutual funds, many diversified exchange traded funds enjoyed solid inflows.

Perspectives

The aftermath of the Great Recession is an appropriate time for investors to take stock on where we are and how we got here before peering too far into the future. Effective investing requires a realism that transcends political agendas and economic fashion. The market is unforgiving of unrealistic perceptions and uninformed views.

In this regard the July 27, 2010 Blinder and Zandi report – “How the Great Recession Was Brought to an End” – is essential reading for every thoughtful investor and advisor. Major complex economies require sophisticated mathematical models and careful informed thought for effective analysis. Employing a standard macro economics model, Blinder and Zandi assess what would have happened without governmental intervention including monetary and fiscal action during the final months of the Bush administration and the first months of the Obama administration. In the report they argue that the critics of the policies are very wrong. They find that the combined effects probably averted what would have been called the Great Depression 2.0. As the report notes, without the government’s response, GDP in 2010 would be about 11.5% lower, payroll employment would be less by 8.5 million jobs, and the

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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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nation would now be experiencing deflation. While the effectiveness of any individual element can be debated, there is little doubt that the combination of policies saved the American economy from the brink of collapse. If they had not acted as they did the economy might still be shrinking and the costs to U.S. taxpayers would have been vastly greater.

On August 24, 2010, the non-partisan Congressional Budget Office released its estimates of the number of jobs funded through the Obama 2009 Recovery Act. They note that the Recession led to 8 million jobs lost between July 2007 and July 2010 while cost was a modest increase of \$27 billion over the projected deficit without the Recovery Act. The report estimated that the Act raised the real level of GDP between 1.7% and 4.5%, lowered unemployment between 0.7 and 1.8 %, increased the number employed between 1.4 and 3.3 million, and increased the number of full-time equivalent jobs by 2.0 to 4.8 million compared to what would have been otherwise in its absence. The effects of the Recovery act are projected to diminish during the second half of 2010 and beyond.

The Obama Recovery Act reflected what was politically feasible not economically desirable. Aggressive monetary and fiscal expansion and reconstruction of the financial sector was still needed. While the resulting policy was effective, it was greatly inadequate. The consequence of inadequacy is that the administration has lost credibility with the public and the chance of renewed fiscal expansion has disappeared. The likelihood of a lengthy period of weak growth and heavy joblessness is high. There have been many reminders of the impact of removing federal support in a fragile economy.

The European sovereign debt crisis was a major factor in the downturn experienced in global markets in the second quarter. The eurozone's major players backed the euro with a loan program that calmed fears. But the success of the eurozone's attempt to enforce fiscal discipline with spending cuts and tax increases is open to question. Recent demonstrations in many European capitals may only be the beginning of the difficulties faced by economies attempting debt reduction. Rising unemployment will not be easy to dismiss politically. In the meantime European economic gains have fizzled. Business activity has sunk to seven month lows. Ireland's bonds plunged as the economy contracted nearly 5%. European consumers are reluctant to spend in the face of government imposed austerity. The notion is spreading that Europe may be stagnating.

The prospect of currency wars is gaining prominence. China's policy of supporting the renminbi relative to the dollar makes Chinese imports attractive and American goods unattractive. Chinese currency policy is a subsidy to exporters for promoting full employment in China. But the same policy promotes continued high levels of unemployment in the U.S. and elsewhere. Jawboning China to allow the renminbi to rise is one of the few tools left to the administration for reducing unemployment. While China is trying to avoid inflation the U.S. is trying to avoid deflation. A trade war is

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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.

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Research

New Frontier is pleased to announce the presentation of our research on “Dynamic Portfolio Monitoring” at the Journal Of Investment Management conference this October. This paper addresses a largely neglected component of modern asset management: how to effectively decide when trading is desirable. Portfolio monitoring decisions in current practice are largely ad hoc, often based on little more than simple calendar rules. This new research provides a rigorous, effective, yet practical dynamic context for deciding when trading is likely to be effective. The research is computationally, statistically, and financially state-of-the-art. It continues the New Frontier tradition of providing the most advanced and effective investment technology available to the investment community.

not a blessing for anyone. The world economy can only rebalance if China stops accumulating excess reserves. Few have hopes that diplomatic efforts or congressional legislation will do more than window dressing anytime soon.

Look Ahead

A simple explanation for the turnaround in capital markets in the third quarter and the year is the accumulative impact of small but positive factors in the economy. Jobs are up, income is up, business investment is up, rates remain low, p/e multiples seem cheap, savings are up, earnings are up, the BP oil spill is over, the May flash crash is better understood, and profits are up. Companies are buying back more of their stock with cash on hand which has compensated for a lack of participation by cautious retail investors. But however real the recovery, it is fragile and highly sensitive to exogenous shocks in the global economy. The issue is whether there is enough momentum for sustainability.

Important economists have warned that the combination of European fiscal tightening and political inability to stimulate the U.S. economy could lead to a deflationary spiral. Inflation is a lagging indicator of economic activity and is seen falling as the economy wrestles with high unemployment. Recently the Fed proposed a program of quantitative easing that is focused not on lowering interest rates but managing inflationary expectations. The program is designed to be a preemptive strategy to avoid an extended period before deflation becomes entrenched, as it did in Japan. The risk is of a substantial weakening of the dollar. While a weaker dollar should boost exports and foster import price inflation it is at odds with other central bank objectives. The policy may cause a surge of buying of dollar denominated assets by other central banks keeping yields very low for some time.

As did the Great Depression, the Great Recession creates political turmoil and economic uncertainty. Businesses are lost, careers ended, and families struggle to survive. While Europeans demonstrate against fiscal austerity and budget cuts Tea Party advocates demonstrate against more government spending and government programs. The mid-term elections in the U.S. seem poised to result in at least two years of political and economic stasis. The administration may be forced to choose between vetoing tax cuts or accepting them without spending cuts to pay for them.

Unemployment should be the focus of fiscal and monetary policy. It is not only a signpost of ultimate success in returning the American economy to full productivity; there is also a moral and ethical imperative to relieve the suffering of American citizens. Infrastructure, education, competitiveness can't be addressed adequately without a fully functioning productive economy. The longer high rates of unemployment persist, the longer the essential problems of the American economy are neglected.

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Announcements

New Frontier is the proud sponsor of the Harry M. Markowitz award for papers of distinction published in the Journal Of Investment Management. The awards will be presented for the first time at the spring conference in 2011 in San Diego with Dr. Markowitz attending. Our website has more information on these and other announcements.

Recent experience has shown that a strategic core portfolio may be very useful even in the most volatile of markets. While modern portfolio theory isn't dead, achieving an effective level of diversification is not simple or easy. Most portfolio optimizers exacerbate statistical errors and often result in portfolios that have little long term investment value even if they appear diversified. Effective diversification requires advanced investment technology. An effectively diversified core strategic portfolio with exchange traded funds is a valuable component of a well defined investment program for many investors.

Effective global diversification at an appropriate systematic risk level remains the most likely route for core investors to optimally meet long term objectives. Innovation remains the ultimate source of economic growth in global capital markets.

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