2nd Quarter 2017 Commentary

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The second quarter turned out to be in many ways similar to the first quarter with several possible pitfalls, yet the capital markets continued to drive higher. Just like last quarter, capital market asset prices rose for stocks, bonds and real estate, while commodities continued to experience deflationary pressures. Further, the global economy continued to experience the "right" level of growth: enough growth to lead to equity earnings improvement, but not enough for anyone to be concerned about inflation. In turn, The Federal Reserve Board (Fed) continued its tightening campaign with a rate hike, which left the Fed Funds Rate at 1% at the end of the quarter. Investors feel that they can buy stocks without worrying about a recession, and that they can buy bonds without worrying about inflation. Investors' capital continued to flow into both global stock and bond markets during the quarter, reinforcing solid market gains and good relative returns for Frontier Asset Management investors.

Apparently, none of the unfolding of 2017 was a surprise to investors. Market volatility crept down to all-time lows for the quarter. The trend is your friend, not much to report here – quite a boring but prosperous market environment.

Don't get us wrong, we are not particularly looking for "excitement" in capital markets' prices. On the contrary, we are very pleased for our investors when market prices experience steady, methodical increases, and when Frontier investors experience above average returns. However, we do manage strategies with downside risk management being our first and primary consideration, and capturing market returns second. It always feels a little uneasy when returns of all assets continue to push new limits, and when perceived risks in the marketplace reach for all-time lows.

Alas, we worry. Even in the best of times, we worry about the future and possible poor outcomes. We do not get to go back in time, nor can we magically make the good times continue indefinitely. Investors have to go forward and sometimes the future unfolds in unexpected ways.

Looking forward, the current conundrum can be viewed through the eyes of stock investors vs. bond investors. It is an age-old relationship that stocks like a good economy and high-quality bonds perform well in a poor environment. Stock investors continue to celebrate small economic gains, and solid earnings improvement. Bond investors continue to point to collapsing commodity markets, aging populations and poor demographics, a tired and shrinking consumer base, and record high debt levels, as the harbingers of future deflation. However, in 2017, both stocks and bonds continue to perform well, even surprisingly well. Investors, awash in liquidity, continue to pour money into all capital asset markets, leaving it very hard to tell which future opinion is right and which is wrong.

Either way – whether the economy is solid and improving, or if deflation is looming on the horizon – it is apparent that all capital markets now carry high prices and are priced for lower future returns. When asset prices are high and expected returns are low, the risk of future possible loss is higher – despite the evidence that investors see almost no risk on the horizon. This is always the case, though: risk appears when investors least expect it, and it is almost never what they predicted. We don't have to look too far back in time to remind ourselves of all the unpredicted outcomes that have occurred in capital markets and the losses they can bring.

We are downside risk first managers, and in all environments we are concerned about poor future outcomes. We have also been managing client portfolios long enough to know that investors feel euphoric or petrified at the wrong times. Part of our job is to know what environment we are in and to counterbalance those emotions: to help investors make measured long-term investment choices and to not fall victim to emotional, knee-jerk, irrational decision-making. So, when times are good, but the future is unclear or even risky, we are never euphoric. Similarly, when investors are petrified and when prices are low and expected returns high, we are usually optimistic about the future prospects and will speak as such to help investors understand the future opportunity. At times like this, when past returns are great, it is easy for investors to extend their risk and to chase returns. Many do. However, maintaining an unemotional stance towards the past, and being measured and logical about the future has always proven to be a more sensible approach.

2nd Quarter Strategy Review

The capital markets followed up their strong first quarter of 2017 with a strong second quarter, too. All of Frontier Asset Management's Globally Diversified strategies also had solid returns in the quarter, and all of them outperformed their blended benchmarks. The performance of the funds in the strategies was a positive contributor once again in the quarter. Although the strategies are all currently being managed somewhat conservatively – focusing more on downside risk than on return – asset allocation was overall a positive contributor to returns, as well, in the quarter. While the most conservative of the Frontier strategies were negatively impacted by underweight allocations to fixed income since return expectations are low and downside risk prospects are high, the more aggressive strategies were helped by their overweight allocations to emerging markets equities even though the overall allocation to equities was less than benchmark. Also, the more aggressive strategies hold long-term Treasury allocations to help with our downside risk management, and Treasuries had a stronger quarter than would have been expected considering how well equities performed.

Year-to-date performance of the Globally Diversified strategies is very good, too, and is particularly good considering the across the board conservative posturing. One-year results continue to be the only commonly publicized performance period when the Globally Diversified strategies trail their benchmarks. Some of the shortfall is due to our conservative posturing to keep downside risk in check. Most of the shortfall, though, is due to the strategies' poor performance in November and December of last year when our fund managers as a group were not positioned well for the markets' reaction to a Donald Trump presidential victory. Longer-term performance continues to be good relative to benchmarks for all commonly shown performance periods back to our strategies' inception dates.

Frontier Asset Management's unconstrained Alternative Strategies also did very well in 2017's second quarter. Even Absolute Return beat the average performance of hedge funds, as measured by the HFRX Global Index. Fund performance was the main positive contributor to Absolute Return's performance in the quarter, while, the key driver of the positive performance for Absolute Return Plus and Focused Opportunities was their asset allocation mixes, which are slanted toward emerging markets stocks and long-term Treasuries, two of the quarter's better performers. Longer-term performance for these strategies continues to look favorable relative to the hedge fund universe and alternative strategies available in mutual fund formats.

– Gary A. Miller, CFA

Additional Information

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