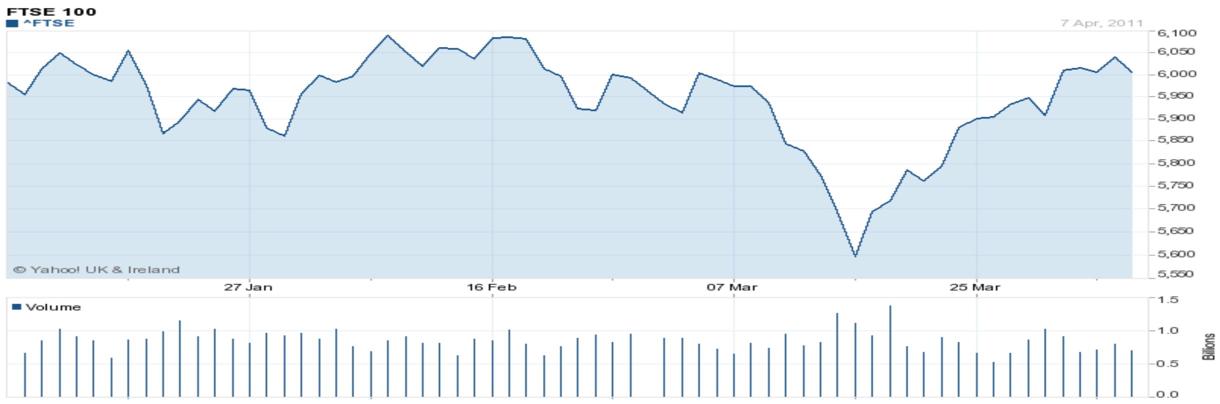
Quartet Capital Partners LLP

Client Newsletter April 2011

Welcome to the first Quartet Capital Partners newsletter of 2011. As you will see we have changed the format slightly following feedback from readers. We hope you like it but please come back to us with any further thoughts or comments.

Review of the last quarter

Stockmarkets have been fairly restless over the first quarter with movements becoming much more volatile and pronounced. Surprisingly given what has occurred over the period the value of most developed markets was close to being unchanged.



The increase in volatility over the period presents a dilemma for investors. On the one hand there are a growing number of serious macroeconomic worries (a "Wall of Worry") that could shock stockmarkets and push them lower, and on the other hand there are a number of factors supporting current equity market levels.

Looking at the"Wall of Worry", the following events raised their ugly heads:

- **Euro-zone sovereign debt crisis.** Following Greece and Ireland, Portugal has now finally sought a bailout, despite previously trying to convince the world that they did not require help. Will Spain be next? Commentators continue to say they will not be a casualty, but then they said the same about Greece, Ireland and Portugal. What does this mean for the future of the Eurozone and the Euro?
- **The UK austerity package.** The UK is just beginning to feel the effects of the austerity package and spending cuts announced by the government, impacting an already squeezed consumer and increasing the number of public sector workers out of work. Add this to weak growth and there is a distinct possibility of the UK suffering a double dip recession.
- **Inflation in the East.** Inflation in emerging markets, China in particular, is still rising and questions are being asked about whether these countries have the experience to implement remedial policies appropriately.
- **Civil unrest in the Middle East & North Africa.** Whilst events appear to be calming down in these countries, oil prices continue to rise and will affect global growth if they do not fall back.
- **Disasters in Japan**. Both the natural and man-made disasters in Japan have caused the biggest shocks to markets over the period.

Despite there being plenty to worry about, you will notice from the chart that stockmarkets have remained resilient, bouncing back quickly after any shocks, and this buoyancy is due to several factors:

- **Investor confidence.** General positive sentiment towards stockmarket investments is increasing again. Investors are looking for opportunities to buy rather than reasons to sell.
- **Inflationary pressures.** Mild levels of inflation, between 1% and 4% per annum, are historically good for stockmarkets.

- **Low interest rates.** Low interest rates and rising inflation have forced investors to look around for alternative sources of income. Yields on many equities now exceed that available from bonds.
- **Asset allocation shift.** There continues to be a general shift away from bonds into equities. As inflationary pressures increase, expectations of a rise in interest rates also increase. Whilst this is good for any investors seeking income, it will potentially hurt investors already holding bonds, as a rise in yield equates to a fall in the value of the bond. The 30 year bond market rally looks like it is on its last legs.

What does this mean for client portfolios?

Following our latest Investment Committee meeting at the end of March, which is held in conjunction with Absolute Return Partners, we have summarised our overall views of the major asset classes below, and briefly provided our thoughts on what this means for portfolios.

Equities

Positive	Neutral	Negative
· US · UK	· Japan · Europe	· Asia · Emerging Markets

Overall we are marginally positive on equities, especially given the tail wind provided by governments' accommodative monetary policy and solid corporate earnings. As a consequence we have increased our equity exposure by up to 10% over the last two months, depending on the investment risk mandate.

We continue to have a bias towards the US and the UK, and even after the pullback in Emerging Markets over the last few months, we still think the region remains expensive on a risk adjusted basis. At some point, however, there will be a time to invest in the region, and we are watching closely for potential opportunities.

We should highlight that, even taking into account the increase in exposure, all portfolios are only marginally above our neutral, or strategic, equity weighting.

Fixed Interest

Positive	Neutral	Negative
· Long/Short Corporate · Investment Grade Corporate	· Index Linked Gilts · Longer dated Gilts	· Short dated Gilts · Emerging Market debt · High yield debt

Looking at the asset class as a whole, we have made our biggest changes here. We have significantly cut exposure over the quarter and also made significant changes within the allocation. We agree with the consensus that the 30 year bull market in bonds is probably over, and that conditions are likely to become less favourable if interest rates rise.

As a result we have made significant cuts to our short-dated government gilt positions for portfolios and added the proceeds to both long/short and investment grade corporate debt. New corporate debt exposure is being accessed via a fund called the New Capital Wealthy Nations Bond, and we have included some further details later as we feel the manager takes a rather unique investment approach.

Overall, despite our more negative view, bonds remain an important source of income for many clients. They are also a less volatile asset class than equities, thus provide diversification, and have traditionally proven to be a useful hedge against potential stockmarket falls. As a consequence there will always be a place in portfolios for the asset class.

Alternatives

Positive	Neutral	Negative
· Absolute Return · Hedge Funds	· Structured Return · Infrastructure	· Commercial Property · Private Equity

We remain very positive towards Hedge and Absolute Return funds, although fund returns have been mixed year to date. We maintain a bias towards managers that are macro (global economic theme) orientated in nature and have little exposure to equity-related strategies.

We continue to hold a negative view when looking at commercial property, as property valuations have now reached a level where we feel capital returns will probably be minimal over the next year or so, meaning any return seen would potentially be from income.

Commodities

Positive	Neutral	Negative
· Gold	· Agricultural · Hard Commodities	

Given the "Wall of Worry", we maintain a position in physical Gold for portfolios as a form of disaster insurance. It acts as a useful hedge against potential market falls and also a partial inflation hedge.

Fund news

Going forward we intend to provide a little more commentary on the holdings we use, to help you understand our thoughts and process when investing for portfolios.

Given our negative view of fixed interest as an asset class at the moment, we thought you may find it interesting to see why we have recently added the Wealthy Nations Bond fund to many portfolios.

New Capital Wealthy Nations Bond Fund (WNBF)

WNBF is a government/corporate bond fund managed by Stratton Street Capital. Based on an original strategy the managers have been running as a private mandate since 2003, this fund was launched to the wider public in September 2009.

The basic premise of the fund is that it only wishes to hold bonds in "wealthy" countries, i.e. a country, and companies within that country, that have strong enough balance sheets to re-pay the bonds they issue. As a result, the fund manager ignores rating agency assessments, and instead uses an in-house model to look at countries with the least accumulated national debt. However, they do not just look at the government's outstanding debt, they also take into consideration the corporate and household debt in each country, as well as looking at how much is held in the hands of foreign investors. In other words, they consider how indebt the nation is as a whole.

When glancing down the list of countries Stratton Street consider amongst the most indebt, there is a large degree of correlation with those countries receiving some of the highest ratings by agencies such as Moodys and Standard & Poor. As a consequence of these rating agencies, bond indices, and funds managed according to indices, tend to allocate the greatest weight to these indebted countries. WNBF specifically does not do this, and due to its process several countries highlighted by rating agencies as the "strongest" are relegated to the bottom of the pile. For instance, using their model Iceland, Greece, Ireland, Portugal and Spain (the next Eurozone casualty?) have been amongst the least investable countries since the strategy began in 2003. WNBF, as a result, has avoided all the Eurozone sovereignty problems of the last couple of years.

We feel the fund is taking a very sensible, more defensive, approach to investing in bonds, which has helped it significantly outperform bond indices whilst maintaining a strong income yield (around 5.5% at the time of writing). As mentioned, the fund is not constrained to any benchmarks, and we should highlight that it only purchases investment grade bonds. In our view it is a good addition to portfolios.

Quartet news

We are delighted to confirm that we have added to our headcount during the quarter. Emma Birch joined us at the start of the year and will be helping out with the administration of client portfolios.

A reminder of what we do

Quartet Capital Partners focuses on providing discretionary investment management services to high net worth private clients. We believe that the approach we take really is ***different.***

Absolute Return Partners LLP is a founding partner of Quartet and we rely heavily on their economic views and analysis in constructing Quartet's portfolio asset allocations.

We believe that there are a few key points about Quartet's investment approach that make us different.

- ***Bespoke portfolios.*** We do not believe in shoehorning clients into predetermined investment solutions, therefore all client portfolios are managed on a bespoke basis.

- ***Portfolio construction.*** We start by addressing each individual client's risk profile which in turn yields a strategic asset allocation. This is then adjusted tactically depending upon our macroeconomic views to finally arrive at a bespoke client portfolio.

- ***Asset allocation.*** We believe (and studies have shown) that asset allocation is by far the biggest driver behind investment performance. This is what we focus on getting right, and where we believe we add significant value.

- ***Investments.*** Very few fund managers consistently beat their respective index and they also tend to have high fees and costs. We therefore use passive investment vehicles for core portfolio holdings. Tactical investments which make up the balance of most portfolios are specific investment counters or actively managed funds which are included to try and produce the best risk-adjusted returns (add alpha). All portfolios are managed on a multi-asset basis to diversify risk.

- ***Chartered investment professionals.*** We are a team of investment managers who have all attained chartered status, have worked together for a number of years, and specialise in managing personalised investment portfolios for private clients.

If you have any questions, queries, comments and feedback, good and bad(!), or if you are interested in a confidential meeting with Quartet Capital, please contact Colin McInnes, Managing Partner, on (020) 8939 2920 or via email at cgm@quartetcapitalpartners.com.

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