

Client Newsletter March 2016

Welcome to the second Quartet newsletter of 2016. As always we hope you find it of interest and please do not hesitate to drop us a line if you have any questions or comments.

Review of the year to date

Over the first quarter of 2016 global equity markets have enjoyed a volatile ride, falling sharply in January and early February before staging a partial recovery. As a result the FTSE 100 delivered a return of -1.1% over the course of the first quarter.

FTSE 100 Index (1 January – 31 March 2016)



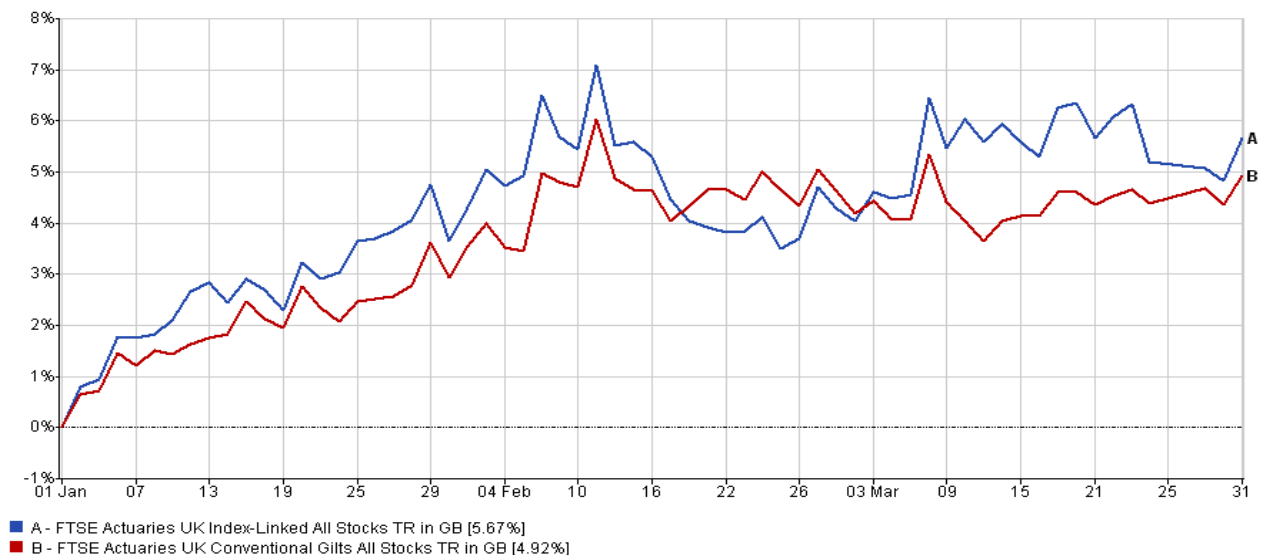
Source: Portfolio Sharing

By way of comparison for Q1 2016, the Nikkei 225 fell 12%, the Euro Stoxx 50 fell 8% and the S&P 500 fell 0.7%. The standout performer was emerging markets which rose over 8%, a welcome recovery given their poor performance in 2015.

Continued concerns about China's outlook and the trajectory of the global economy weighed on sentiment at the start of 2016, causing a steep drop in global risk assets during the first few weeks. However, the tone reversed sharply in February amid a steady U.S. economy and easier global monetary policy, including the US Federal Reserve softening its rate-hiking stance.

The Bond Market (1 January 2016 – 31 March 2016)

The chart below shows the UK Gilts (red) and UK Index Linked (blue) government bond indices during Q1 2016.



Source: FE Analytics

31/12/2015 - 31/03/2016 Data from FE 2016

As can be seen government bonds provided a strong positive return over the first quarter returning 2.9% for conventional Gilts and 5.7% for Index Linked Gilts. It was particularly pleasing that these positive returns showed a negative correlation to equities and acted as a hedge to risk assets.

Corporate bonds also did well in a relatively benign economic and monetary environment.

Outlook

Our views for the rest of 2016 are little changed from Q1 and in brief we expect:

1. Slow but positive economic growth with limited recession risk.
2. The path of the US dollar and central bank policy remain key factors this year.

The start of 2016 saw the post-global financial crisis expansion enter its seventh year. U.S. GDP grew for the 20th straight quarter and continues to expand despite volatility. Yet on many metrics, sentiment is fragile. High yield bond spreads hit a post-crisis high, oil fell to a 13-year low and global equities flirted with a bear market. We maintain our expectations of subdued growth but no recession, and note that equity bull markets are often seen to “climb a wall of worry.” But this is no ordinary wall of worry. So despite our conviction in low but positive growth, we retain a cautious tone. Some of the recent market turmoil can be traced back to policy divergence and waning confidence in central banks. Anxieties around the start of the U.S. hiking cycle in the face of lacklustre growth were an acute issue early in the year, but these are dissipating as the US Federal Reserve moderates its path of hikes to balance U.S. domestic strength with global vulnerabilities. The case for positive growth in 2016 is underpinned by the strength of U.S. consumption, household balance sheets and the labour market.

The path of the U.S. dollar remains a key consideration. We expect some residual strength but see the dollar consolidating by mid-year as the market prices in the Fed’s path of interest rate rises. A consolidation in the dollar could improve the outlook for emerging markets and U.S. earnings, while pragmatic central bank policy around the globe is critical for stable financial conditions and risk appetite in general. If more stable and uniform global growth aids dollar consolidation, that would signal increased risk appetite. However if the dollar falters because of sputtering U.S. growth, the outlook would darken for risk assets generally.

Ultimately, we remain modestly optimistic about global growth and anticipate a more virtuous end to the dollar cycle, but the risks to this core view reinforce our more cautious asset allocation stance.

Comments on Brexit

Given how topical the subject is at present we thought we would give our views on the subject of potential Brexit.

The latest opinion polls suggest an extremely tight vote but this could easily change due to, for example, another escalation in the Greek crisis, further rises in net migration from Europe or an escalation of the refugee crisis. In addition, the nature and extent of any renegotiation of the terms of British membership could also be important in determining the referendum outcome.

If the vote is to leave, our long-term view is that the UK economy is robust enough to cope, though the outcome would probably be a slight negative. The European economies won’t want to risk their £60bn annual trade surplus with the UK, so establishing sensible trade agreements is likely to be a priority for all parties. UK services exports would be most at risk, as there is currently a £15bn trade surplus in services with the EU (e.g. financial, accounting and legal services), and it may become harder to do business with EU institutions. Savings to the UK from not paying EU contributions might well be offset by falls in services exports and the big unknown is what charges the EU may levy to gain access, much like they charge Norway.

A useful summary of what we think the Market Impact of an “out vote” will be is detailed below:

SHORT TERM

LONG TERM

STERLING	The UK currency seems to be bearing the brunt of Brexit uncertainty. Sterling could fall further, but with the odds still in favour of staying in, it could bounce ahead of the vote.	We disagree with the consensus view that sterling will collapse if a Brexit vote materialises. In our view sterling is already slightly undervalued on a long-term basis, and any significant further weakness might provide an opportunity to buy UK assets more cheaply.
EQUITIES	Global developments are far more important for UK equities, for example the current views on a global recession and China slowdown fears. However, expect short-term volatility to the downside.	The FTSE 100 is currently valued more cheaply than small and mid-sized UK companies, due in part to its international exposure amid global recession fears and its weightings of energy and mining companies. We don't expect it to be hurt much by trade disruptions if the UK were to leave the EU.
BONDS	Demand for the perceived safe-haven of gilts could continue in the near term.	Any Brexit-related weakness in UK corporate bonds would make them more attractive to long-term investors looking for income, as yields remain at historically low levels.
PROPERTY	There is some evidence of a buyers strike ahead of the vote, which could continue.	We would expect buyers to return at higher yields given that favourable income streams and our view that the UK economic recovery will continue, regardless of how the referendum turns out.

A broader summary of the sources of possible gains and losses:

Gains

- Less regulation
- Savings on European Union contributions
- Ability to strike new trade deals
- Skills-based migration policy

Losses

- Possible tariffs on exports to the European Union
- Loss of access to the single market
- Damage to the City
- Drop in investment caused by uncertainty

Source: Capital Economics

In summary in the event of an “out vote”, all UK asset classes would be impacted in the short term as they digest the longer term implications. However we are confident that ‘life will go on’ for the UK corporate sector without a large negative impact, though in our view Brexit would introduce some risk for little tangible economic benefit. Mark Carney, for example, has warned that Brexit is the biggest risk to the UK’s financial stability

A good gauge on the likelihood of Brexit actually happening is the odds on offer at the bookmaker. Historically they have been much better at predicting events compared to pollsters. At the time of writing the odds offered of staying in is 56% so still a close run thing.

What does this mean for Quartet’s client portfolios?

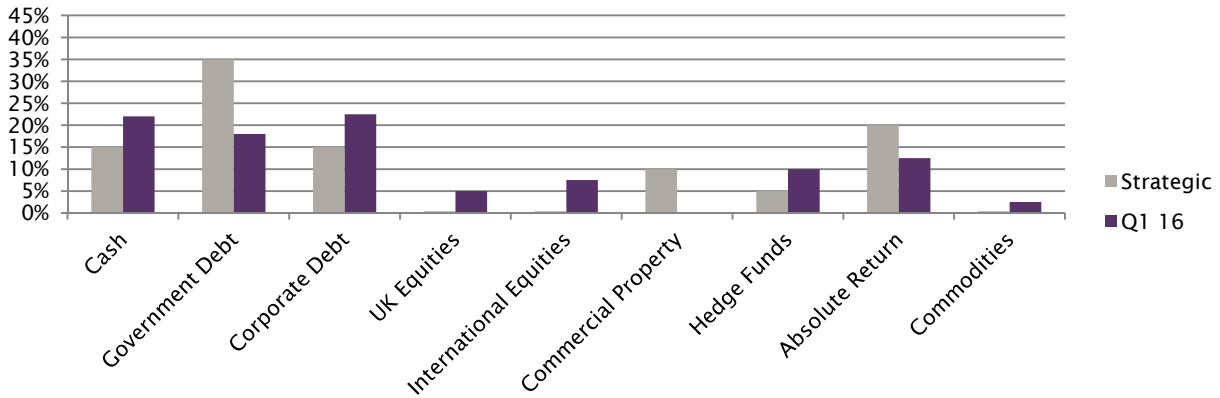
Our prime focus is on the management of client portfolio asset allocations, and as you will be aware the initial building block that we start with in the construction of each client portfolio is one of four strategic asset allocations as defined by the following risk profiles – Capital Preservation, Cautious, Balanced and Aggressive. These long-term asset allocations are then tailored to each client’s circumstances to create a bespoke client portfolio. Client strategic asset allocations are then adjusted on a shorter-term basis depending upon our economic and investment views to arrive at our tactical asset allocations.

There have been changes across all risk profiles in the 1st quarter of 2016 where we have:

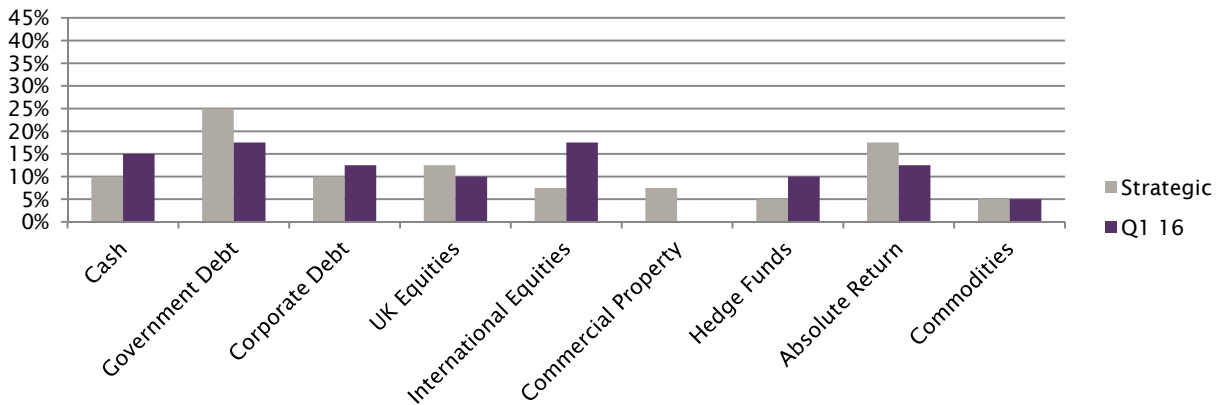
- We reduced our hedged corporate debt position across portfolios due to performance rather than a fundamental desire to reduce our corporate bond exposure.
- Started to introduce a position in a property/infrastructure vehicle for Balanced and Aggressive portfolios and expect to continue to do this for more Cautious portfolios in Q2.

The following four charts show how our tactical asset allocations are positioned relative to the longer term strategic asset allocations.

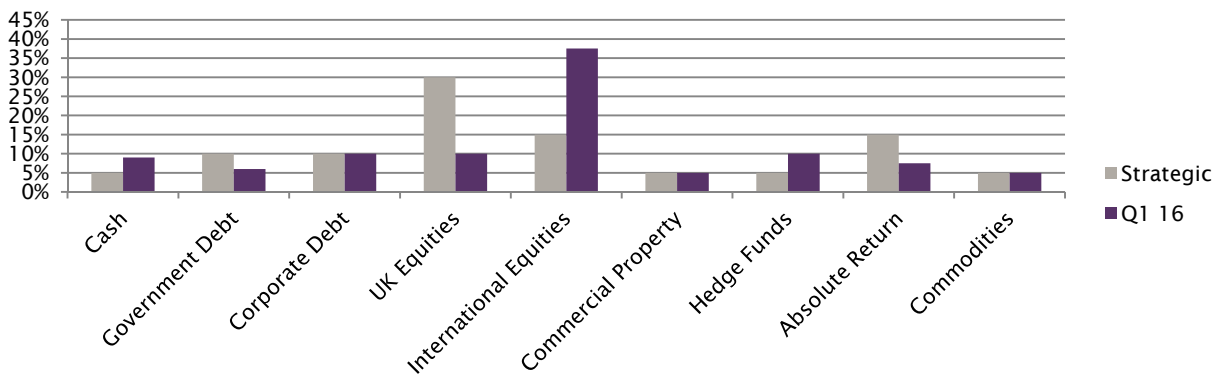
Capital Preservation asset allocation



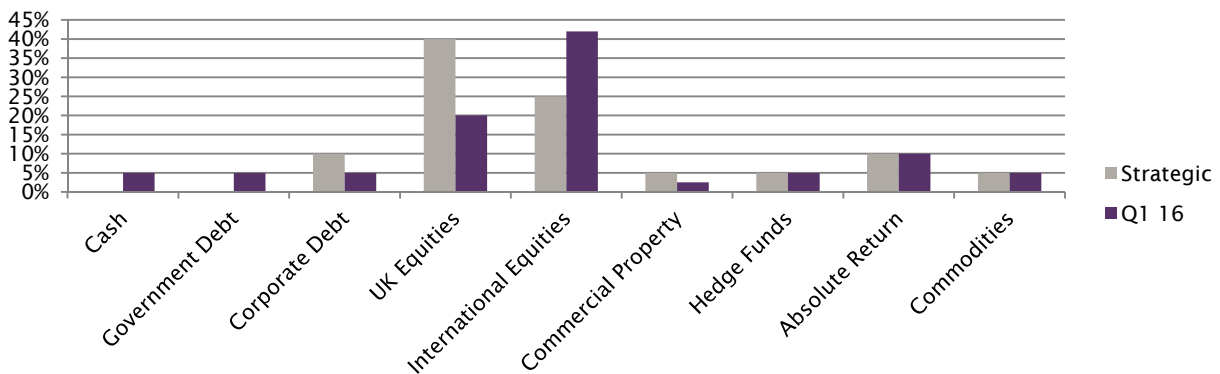
Cautious asset allocation



Balanced asset allocation



Aggressive asset allocation



Comments on the difference between our current and strategic asset allocation positioning

Cash

Given our macro concerns and the current state of equity markets we are neutral to slightly overweight Cash across all portfolios.

Government Debt

We are significantly underweight conventional government debt across all portfolios but rather hold a position in UK, and to some degree US, index-linked securities. This is based on our view that we are at the bottom of the interest rate cycle and there is limited upside especially when interest rates start to rise. In addition their performance is negatively correlated to equity markets in a downturn providing portfolios with some downside protection.

Corporate Debt

We are now underweight conventional corporate debt exposure for all clients for the same reason we are underweight Government debt but our overall neutral to slightly overweight position is the result of exposure to a hedged debt vehicle where we are not taking much interest rate or duration risk.

UK & International Equities

We remain underweight the UK versus overseas where we see better opportunities. As highlighted earlier we continue to favour Europe, Japan and Emerging Markets at the expense of the US where we think valuations are more stretched.

Commercial Property

As mentioned earlier we have started to build exposure to Commercial Property across portfolios. The particular holding leases Primary Healthcare Centres to the NHS so is in part an infrastructure investment. Capital growth has historically been in line with inflation but the yield is close to 7% per annum which we like in the current low interest rate environment.

Hedge Funds

As the Eurozone problems rumble on, volatility will remain in the short-term, and in this kind of environment we would expect this asset class to perform well. Across all portfolios we are neutral to overweight on a tactical basis.

Absolute Return

At present we are marginally underweight this asset class. Absolute return strategies, we feel, will struggle without more long term market directionality.

Commodities

We now have minimal exposure to other industrial commodities due to our concerns about growth rates in Chinese and Asia. However we remain very positive towards Agriculture over the long-term and therefore have exposure across all client portfolios.

A reminder of what we do

Quartet Investment Managers focuses on providing discretionary investment management services to high net worth private clients. We believe the approach we take truly is **different**.

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, 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 benchmark index and they also tend to have high fees and costs. We therefore mainly 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.

If you have any questions, comments or feedback, or if you are interested in a meeting with Quartet, please contact Quartet's Managing Partner, Colin McInnes (cgm@quartet-im.com), via email or on (020) 8939 2920.

Quartet Investment Managers

April 2016

Risk Warning:

This document has been issued by Quartet Capital Partners LLP ("Quartet"), which is authorised and regulated by the Financial Conduct Authority. The information in this document does not constitute, or form part of, any offer to sell or issue, or any offer to purchase or subscribe for shares, nor shall this document or any part of it or the fact of its distribution form the basis of or be relied on in connection with any contract. This financial promotion and the products and services it describes are directed at professional clients or eligible counterparties only. Retail clients may not rely on it. Quartet has not taken any steps to ensure that the securities referred to in this document are suitable for any particular investor and no assurance can be given that the stated investment objectives will be achieved. Quartet may, to the extent permitted by law, act upon or use the information or opinions presented herein, or the research or analysis on which it is based, before the material is published.

The portfolio performance information presented in this letter is estimated, unaudited, net of applicable fees and is subject to change. No representation is being made that the portfolios will or are likely to achieve profits or losses similar to those shown on the monthly performance table. Past performance is not indicative of future results and a client may not get back the amount originally invested.

The law may restrict distribution of this document in certain jurisdictions; therefore, persons into whose possession this document comes should inform themselves about and observe any such restrictions. This letter, the information contained herein, and any oral or other written information disclosed or provided is strictly confidential and may not be reproduced or redistributed, in whole or in part, nor may its contents be disclosed to any other person under any circumstances.

Quartet Capital Partners LLP is a Limited Liability Partnership registered in England and Wales, Company No: OC345770.

Registered Office: 16 Water Lane, Richmond, Surrey, TW9 1TJ.

Authorized and regulated by the Financial Conduct Authority of the United Kingdom ("FCA").

A list of members is available for inspection at the registered office.