

Client Newsletter Quarter 1 2013

Welcome to the first Quartet newsletter of 2013. 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 quarter

Following on from a good year in 2012 equity markets had a stunning start to 2013 with many markets having one of their best ever first quarters producing return that most investors would be happy with for an entire year.

FTSE 100 Index (1 January – 31 March)



Source: londonstockexchange.co.uk

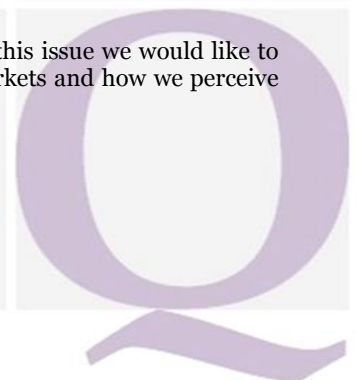
Despite continued weak global growth, risk assets performed very well with both global equities and corporate bonds outperforming cash and core government bond markets. Driving this was the continued low interest rate environment, as central banks maintained aggressively loose monetary policies to help ease the burden of government, bank sector and household deleveraging. Coupled with a short-term resolution to the US “fiscal cliff”, investors perceived little risk in being fully invested.

Outlook

As we have continued to highlight, many concerns remain for the global economy. Whilst some of the issues are bubbling in the background, several remain prevalent:

- Potential unravelling of the Euro.
- Eurozone sovereign debt crisis.
- Fears over weaker US growth.
- Iranian tensions in the Middle East.
- Slowdown in Asia, especially China.
- Global credit deleveraging.

In previous quarterly letters we have commented on one or more of these issues. For this issue we would like to review the recent action seen in Cyprus and will then move on to comment on the markets and how we perceive risk in the current environment.



What happened in Cyprus?

As is so often the case, systemic instability can arise in the places where you least expect and Cyprus is a case in point.

This crisis brought home the brutal reminder of the fact that when you “save” your money by putting it in a bank, you are not really “saving” it at all: you are lending it! A bank borrows from you at a certain rate of interest, and then turns around and lends the majority of that same money out at a higher rate of interest.

The Cypriot banks offered depositors high rates of interest, relative to other Eurozone banks, as high as 4.75 percent for long-term accounts, which attracted not only regular smaller savers, but also significant sums from Russian investors (Cyprus has a double taxation agreement with Russia). It seems that few had learnt the lessons from the Icelandic banking debacle, and by this we mean “higher return almost always equals higher risk”.

How could the banks afford to pay such high interest rates? By investing the money from those “savers” in something that paid even higher rates of interest: Greek Government Debt!

Problems arose when Greece got bailed out as the value of their debt was cut in half resulting in huge capital losses. But that wasn't all: the high interest rate that those bonds were paying was also cut - to just 3.5 percent. That meant Cyprus' banks had a lot less interest coming in from its Greek debt investments but still had to pay their depositors. In some cases they were paying depositors more than they were earning on their Greek debt. In other words, the Cypriot banks were suddenly deep in debt by virtue of the capital losses, but also were not earning enough to make their interest payments. They were on the verge of going bust.

For help, the Cyprus banks turned first to the Eurozone, who agreed to lend them some, but not all, of the capital shortfall. To raise the balance of the funds they attacked the problem at the other end, by reducing the amount they owed. Who do they owe money to? The depositors. They decided to impose significant haircuts on initially all deposits but subsequently relented and removed the haircut on deposits under 100,000 euros.

There are several unique features about the Cypriot bailout, but the most far-reaching has been the ‘bailing in’ of bank senior debt and conventional deposits. While many Western banks would give anything to have the same excess of deposits over loans as the Cypriot banks, their sheer magnitude meant that when the bill was presented to Cyprus for its contribution there was nothing else to ‘bail in’.

Since the bailout there has been the customary Eurozone opining as to whether Cyprus does indeed set the pattern for future bailouts or not. But in many ways that is irrelevant; whatever materialises the spotlight is firmly back on whether deposits are safe or not.

The people of Cyprus are now finding that not all euros are created equal. Any Cypriots with large deposits must be wishing that they had turned them into real assets, thereby avoiding the savage diminution in their value.

Market Outlook

2013 US GDP growth will, in our opinion, be slower than many forecast and we expect below-trend growth to persist for some time. The impact to GDP growth from US fiscal issues is estimated to be in the range of -1.5% to -2.0% in 2013 due to spending cuts and tax increases. Whilst Congress and the Obama Administration can put off many of these tough decisions, yet again it looks like another political battle as Republicans debate how aggressively they should use the borrowing limit as leverage against the White House.

Fiscal issues will continue to haunt the US for years to come, though the ability to raise capital does not appear to be a problem. Quantitative Easing (“QE”) by the Fed and other central banks has continued to suppress yields on government bonds and in many peoples' eyes any perceived tail risk has been removed. As a result investors have piled into government credit markets. Going forward we think there is little left to squeeze out in terms of capital gains. Low yields have forced investors to seek higher returns in higher risk asset classes. The result of this is that investors have moved allocations into equities. However, as highlighted earlier, the outlook in the US and hence for US equities is not all rosy.

We are in the midst of a short-term bull run with global equities up over 20% since last summer. Historically these sorts of rallies stay strong if hopes of economic and profit growth prove correct. When only one of these supporting factors (economic or profit growth) occurred stockmarkets have typically fallen by, on average, 15% over the following year.

Historically the market has been a better predictor of the economy than economists, so dire growth forecasts may be no obstacle to continued upward movements in stock prices. However government bond yields have fallen (prices of bonds have risen) and company earnings forecasts are lacklustre at best.

On the face of it equity valuations, relative to credit or debt, appear attractive. The dividend yield on the S&P 500 is greater than the ten year Treasury, a phenomenon that hasn't happened since the 1950's except for a brief spell

during the 2008-9 financial crises. The concern for us is that equities only look cheap **relative** to bonds and we are wary as to the extent the bond market has been distorted by central bank intervention.

Rather than just present a pessimistic outlook, detailed below are some of the pros and cons of Equity valuations currently:

- The differential between S&P earnings yield and the yields on bonds makes stocks look cheap – **Pro**
- The attractiveness of these relative valuation measures is dependent upon interest rates staying low – **Less Pro**
- Schiller cyclically adjusted p/e ratios suggest full rather than fair valuations – **Con**
- The outlook for earnings is restrained by the uncertain macro environment – **Con**
- Among the things keeping earnings high and thus making stocks seem attractive are some of the highest profit margins in history. If profit margins were to revert towards normal levels this would reduce earnings either taking stock prices down or lifting p/e ratios and reducing stocks attractiveness - **Con**
- Corporate balance sheets are in good health implying some combination of safety, stock buybacks and possible dividend increases – **Pro**
- With markets up over 20% since last summer it cannot be argued that stocks have been overlooked or that attitudes are too negative - **Con**

As always, markets walk the path between greed and fear. Equity investors need to be invested to make money and everyone hates to be left behind when the markets are running. It is however far too easy to be optimistic when markets are rallying and investors find comfort with the crowd. This is dangerous. The best times to buy are when prices are down, when fear abounds. This does not seem to be the case at present and we are becoming more wary.

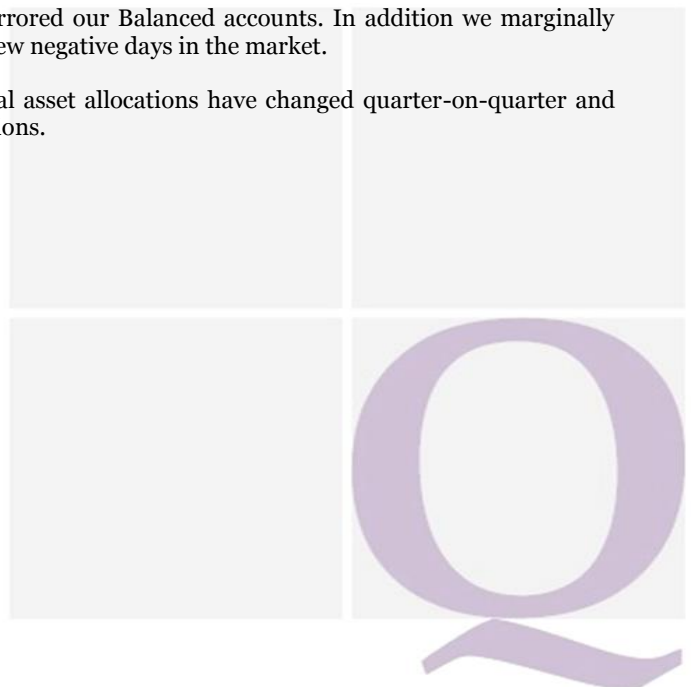
What does this mean for Quartet's client portfolios?

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 – 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 adjusted on a shorter-term tactical basis depending upon our economic and investment views.

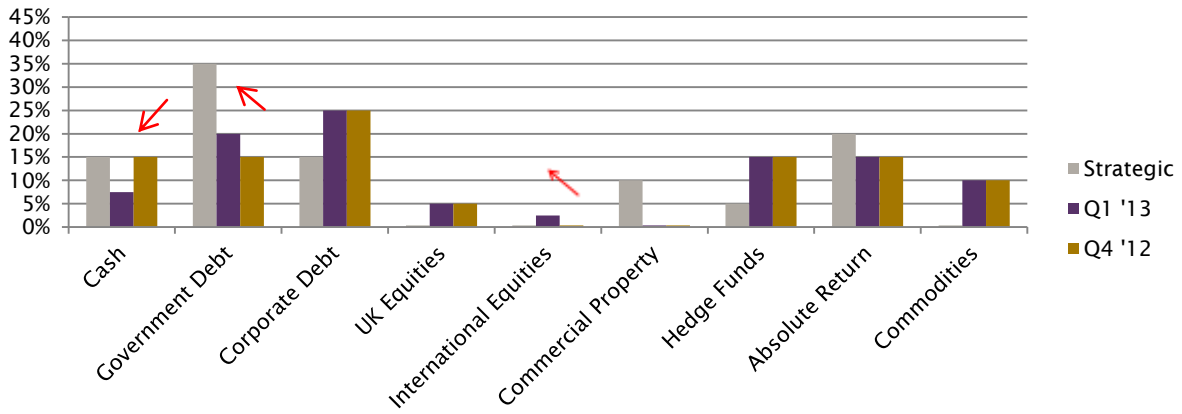
There was little change across asset allocations over the quarter. The main actions taken are as follows:

- **Capital Preservation:** Due to concerns inflation may pick up in the medium term we initiated a position in index linked Gilts. Following the stimulus package announced in Japan we also introduced some exposure to Japanese equities hedging out any Yen exposure.
- **Cautious:** As above we initiated a position in index linked Gilts and Japanese equities. We also trimmed back our European Equity exposure following developments in Cyprus.
- **Balanced:** As above we initiated a position in index linked Gilts and Japanese equities. We took some profits on our Corporate Bond and European Equity exposure and let cash balances rise somewhat.
- **Aggressive:** Our asset allocation changes mirrored our Balanced accounts. In addition we marginally increased our UK equity exposure following a few negative days in the market.

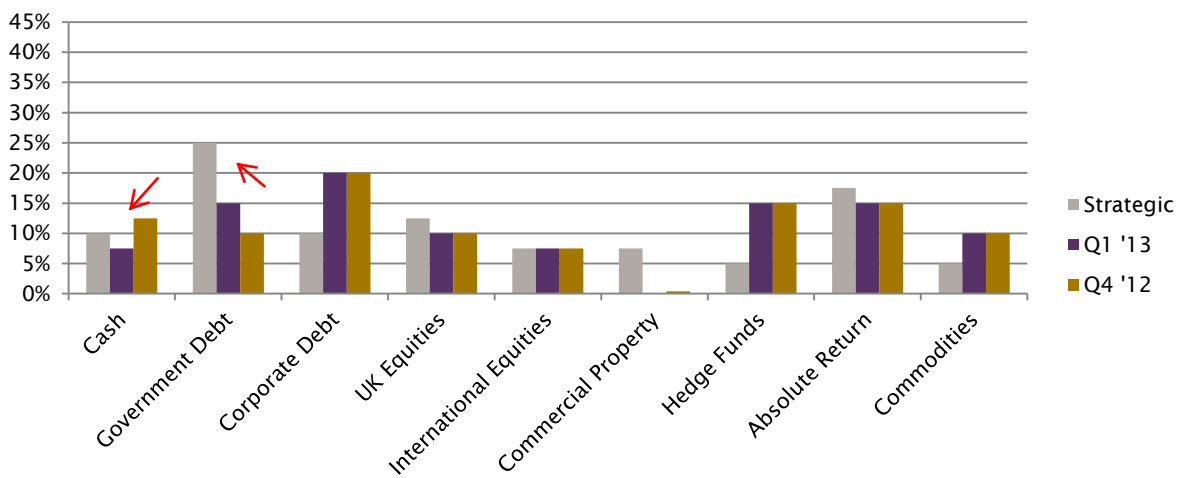
Detailed below are four charts showing how our tactical asset allocations have changed quarter-on-quarter and also the positioning relative to the strategic asset allocations.



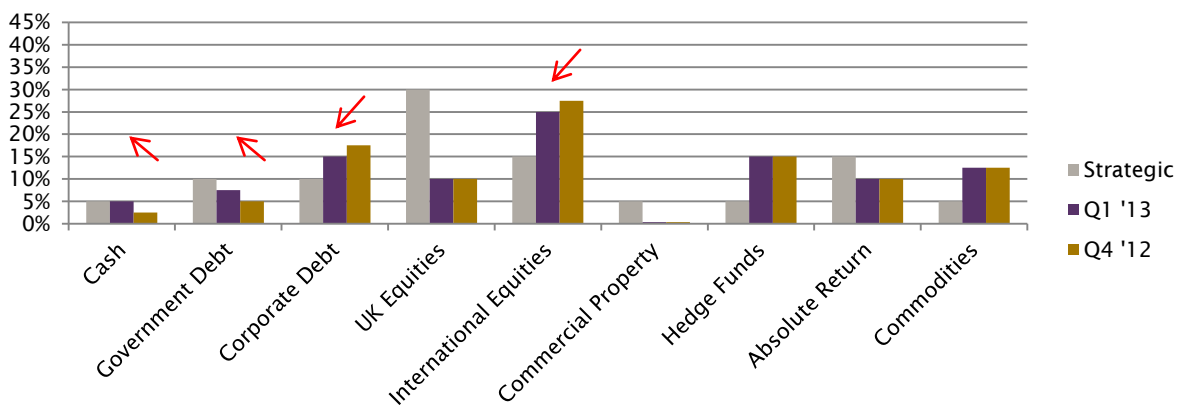
Capital Preservation asset allocation



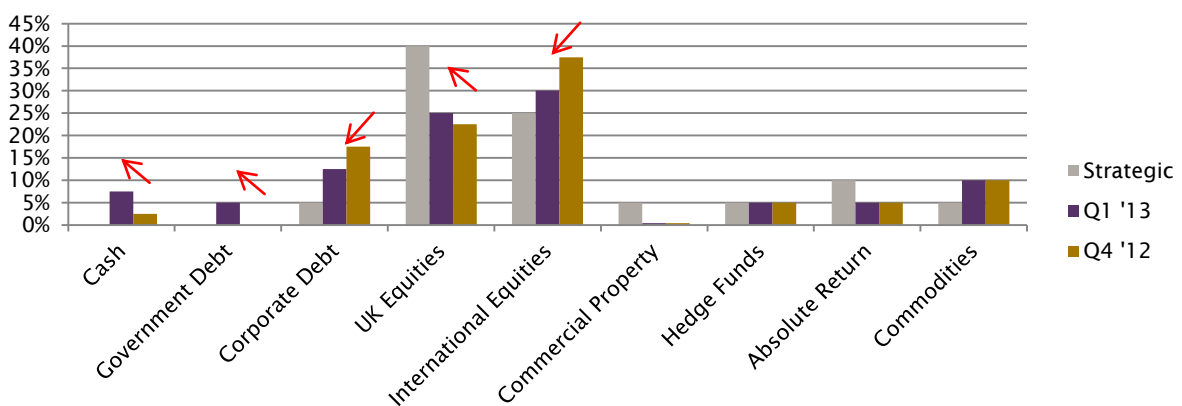
Cautious asset allocations



Balanced asset allocations



Aggressive asset allocations



Government Debt

We are significantly underweight conventional government debt across all portfolios. Instead during the quarter we initiated a position in UK Index Linked Gilts. With breakeven rates falling to around 3.4% we see significant upside should the inflation rate in the UK rise from its current level of around 2.8%.

Corporate Debt

In contrast to our government debt exposure we are marginally overweight corporate debt for all clients. Performance has been strong and we expect more upside. We have however reduced our exposure across various accounts more with a view to realising some of the profits made last year.

UK & International Equities

Whilst at a headline level it appears that we are underweight our strategic equity exposure, part of our exposure falls into commodities where we hold Agricultural related equities. We remain underweight the UK versus overseas where we see better opportunities. We trimmed back our European exposure and initiated a position in Japanese equities (hedging out any Yen currency exposure). As noted earlier, we continue to see value in equity markets if you are willing to buy and hold them for the next 10 years or more! However, short-term we are wary and getting more so.

Commercial Property

We are very underweight relative to our Strategic Asset Allocation weightings, having no exposure at all. Commercial property prices are, over the longer term, correlated to GDP growth. As we expect minimal growth over the next few years we have no property exposure.

Hedge Funds

As the Eurozone problems rumble on, volatility and directionless markets will remain in the short-term, and in this kind of environment we 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. We feel Absolute return strategies will struggle without more market directionality. Volatility as measured by the VIX remains close to historic lows.

Commodities

We are overweight Gold as an asset class, which we use as an insurance policy should a significant macro-shock hit the global economy. We have minimal exposure to other industrial commodities due to our long held belief that the Chinese and Asian economies will slow significantly this year. We are very positive towards Agriculture over the long-term and have exposure across all risk mandates.



A reminder of what we do

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

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

Quartet Investment Managers

April 2013

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.

