Client Newsletter November 2013

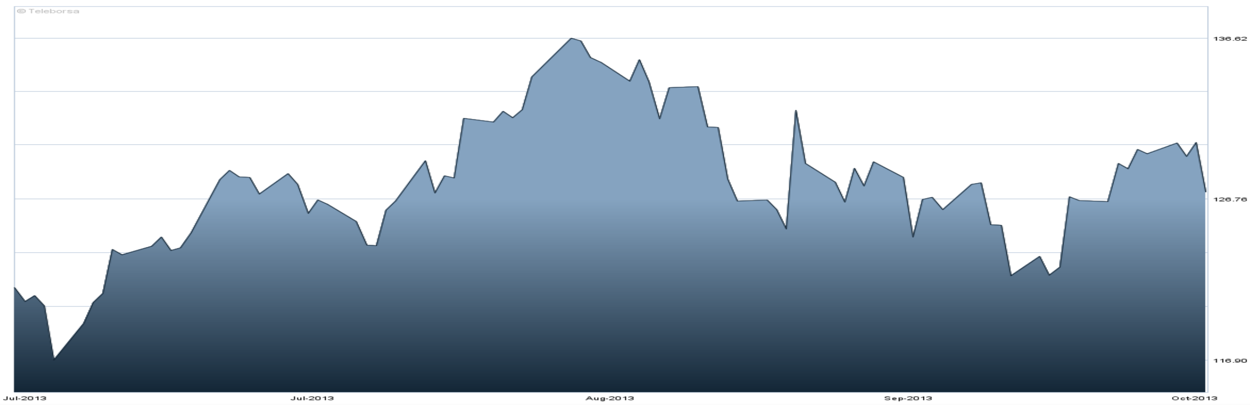
Welcome to the third Quartet newsletter of 2013. As always we hope you find it of interest and please do not hesitate to drop us a line if you have any questions or comments.

Review of the quarter

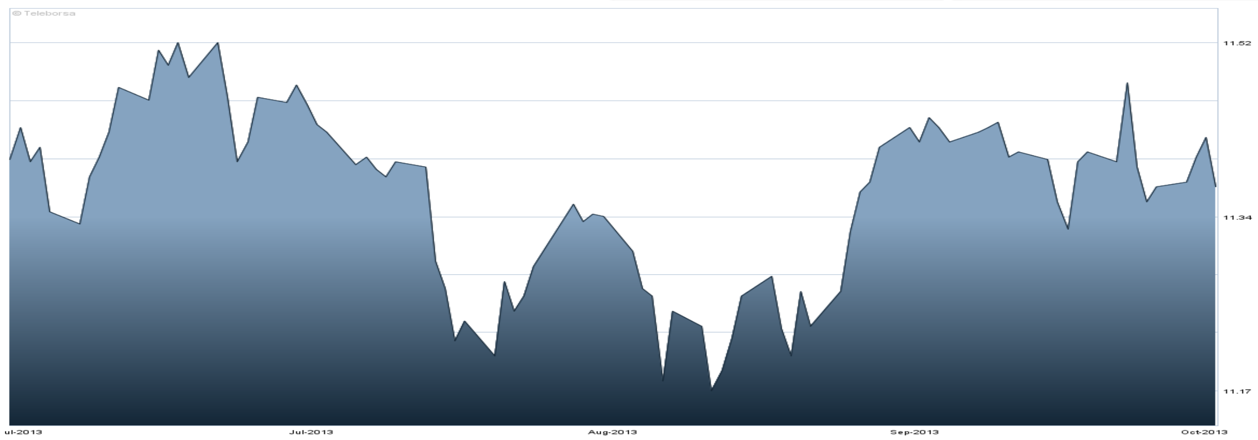
Major markets enjoyed a reasonably volatile quarter starting off strongly before giving up much of the gains towards the end of September. The 4th quarter then started rallying strongly in October.

FTSE 100 Index (1 July – 31 October)

USD Gold (1 July – 31 October)



UK Gilts (1 July – 31 October)



Source: londonstockexchange.co.uk

Following on from our commentary in the last newsletter, markets reacted positively to the news that the US Federal Reserve will, for the time being, continue with its quantitative easing (QE) program.

Although the UK market has slightly lagged other major markets in the past few months, it has still produced a strong return for the year. The recent encouraging return to growth of the UK economy was also good news however it is early days for the recovery and a measure of caution is still required.

The US equity market has continued its meteoric rise, with the S&P 500 index touching record highs as that economy continues to show signs of sustainable growth. However, if US economic growth becomes too robust it will not necessarily be good news for markets, due to the prospect of a reduction in QE and any associated rise in interest rates.

In contrast to the major developed markets, emerging markets are still in negative territory and for international investors the losses have been exacerbated by weakening local currencies.

Outlook

Despite the air of general optimism we continue to highlight, several concerns that remain for the global economy which are bubbling in the background:

- Eurozone sovereign debt crisis.
- Fears over weaker US growth.
- Slowdown in Asia, especially China.
- Global credit deleveraging.

We have commented on these issues in previous newsletters however at this point in time perhaps the biggest elephant in the investment room is Quantitative Easing (QE).
We remain struck by how many investors believe QE is both beneficial and painless – something to be welcomed as if it were just another central bank policy. As a reminder, QE was introduced as an emergency measure to rescue financially stricken economies and whilst most major economies are now on the road to recovery, QE is still with us.

Janet Yellen has been nominated to be the next head of the Federal Reserve. Her speeches suggest that she, like Mark Carney here in the UK, has a strong desire to promote full employment and will therefore only withdraw QE once the US economy is back growing at historic trend rates. QE has therefore entered the mainstream and is here to stay. The problem is that we think it is storing up problems for the future. It is a convenient tool enabling governments to spend far in excess of their revenues and withdrawing monetary stimulus will be difficult as politicians are unlikely to cooperate. Ultimately one of the most likely outcomes will be inflation. The more money that is printed, the greater the eventual problems will be.

Complacency among investors is high. Some refuse to acknowledge that there are tough issues which need to be addressed. Others accept there are flaws, but believe the authorities will be able to overcome these with their unorthodox monetary policies. As of now the jury is still out....

Where next for Bonds?

It appears that we are close to the end of one of the greatest bull markets in bonds where for the past 32 years investors experienced rising bond prices. Government and investment-grade corporate bond yields have declined from their peak in the hyper-inflationary period of the early 1980's when the yield on US 10 year government bonds was 15.8% p.a. to a low of 1.4% in July 2012. The yield is currently around 2.6%.

Some investors are confused by the inverse relationship between bonds and interest rates—that is, the fact that bonds are worth less when interest rates rise. But the explanation is essentially straightforward:

- When interest rates rise, new issues come to market with higher yields than older securities, and therefore for the older ones to match the prevailing yield, their prices go down.
- Conversely, when interest rates decline, new bond issues come to market with lower yields than older securities, making those older, higher-yielding ones worth more. Hence, their prices go up.

Usually, the longer the maturity, the greater the degree of price volatility. If one holds a bond until maturity, one is less concerned about these price fluctuations (which are known as interest-rate risk, or market risk), because you should receive the face value of the bond at maturity. However if you have to sell your bond before maturity, it is likely to be worth more or less than you paid for it.

Various economic forces affect the level and direction of interest rates in the economy. Interest rates typically climb when the economy is growing, and fall during economic downturns. Similarly, rising inflation leads to rising interest rates (although at some point, higher rates themselves become contributors to higher inflation), and moderating inflation leads to lower interest rates. Inflation is one of the most influential forces on interest rates.

The US Federal Reserve has distorted the fixed income market with their QE programme by purchasing bonds to keep their prices artificially high, which in turn has kept long-term interest rates artificially low. Last quarter, they announced that they are considering winding down their bond buying programme, now that unemployment is falling and the housing market is rebounding. The timing of this tapering of QE is uncertain, but will be a critical event for the bond markets and could commence later this year or early in 2014. Without government support, bonds will trade more on their own fundamental merits, and yields will likely move up. It looks like we could be in for a period of sub-par returns for bonds (particularly government), where the risks outweigh the potential rewards.

Despite our caution on bonds we still own some as they generally offer a higher return than cash, but we are highly selective given the potential for a significant fall in prices should QE come to an end. Conventional gilts offer a negative return after inflation and therefore contribute nothing towards capital preservation, so we don't hold any. We do own Index-Linked government bonds as they do, by definition, offer some protection against rising inflation. Given that we believe inflation in the UK is likely to remain relatively high, we think that the rewards should outweigh the risks, so are happy to be overweight Index-Linked bonds for the time being.

Where next for Equities?

We have taken a cautious stance on equities for much of 2013. This reflects our concern over the quality of the economic recovery and company earnings.

There is a worrying disconnect developing between equity markets and the underlying economy. Inflation expectations remain subdued, and the major issue of the long-term unemployed continues to haunt central bankers in the developed world. Those who fall under the definition of the long-term unemployed either cannot find work, or do not want to work and they are therefore omitted from labour market statistics. This has lead to a fall in the unemployment numbers, even thought the actual number of those out of work has risen.

Central banks, most notably the Bank of England and the Federal Reserve in the US, have highlighted employment as a key determinant when considering the withdrawal of QE, so we will maintain our cautious stance until we see an improvement in labour market statistics.

QE was designed, in part, to boost economic activity, but the primary effect has been to boost asset prices. The inflation that many feared (as a result of QE) has not appeared in consumer prices, but has done so in assets such as equities and prime property - not the democratic outcome that governments had hoped for as the rich get richer, and those dependent on wages see their spending power eroded by rising gas prices and low wage growth. Wages can only rise when the labour market improves, however expectations have to be realistic as the unions learned to their cost in Grangemouth!

So how long can equity markets continue to rise? We have no idea! Investors are bullish but corporate profits are barely growing. This is similar to 2007 when expanding price/earnings ratios propelled the market higher. In the US, a number of stocks that can be valued only on revenues or the number of (internet) users has risen sharply this year. Investors appear not to worry about corporate profits as long as sales are rising.

The talk of a reduction in Quantitative Easing appears to have receded and in fact QE is continuing at record high levels. Interest rates remain low and any talk of tapering has shifted investors out of fixed interest securities. As a result money has to go somewhere and has ended up heading into equities.

We are not momentum investors, so we have not been seduced by QE. At some point there will be a reversal in equity markets, and we would rather participate in some of the upside than all of the downside, hence our underweight position in equities. We have therefore been highly selective in our positioning in equity markets. Our conviction on Japanese and European equities combined with their strong relative outperformance has meant that we have managed to keep up with our peer group during the year, but with a lot less risk.

What does this mean for Quartet's client portfolios?

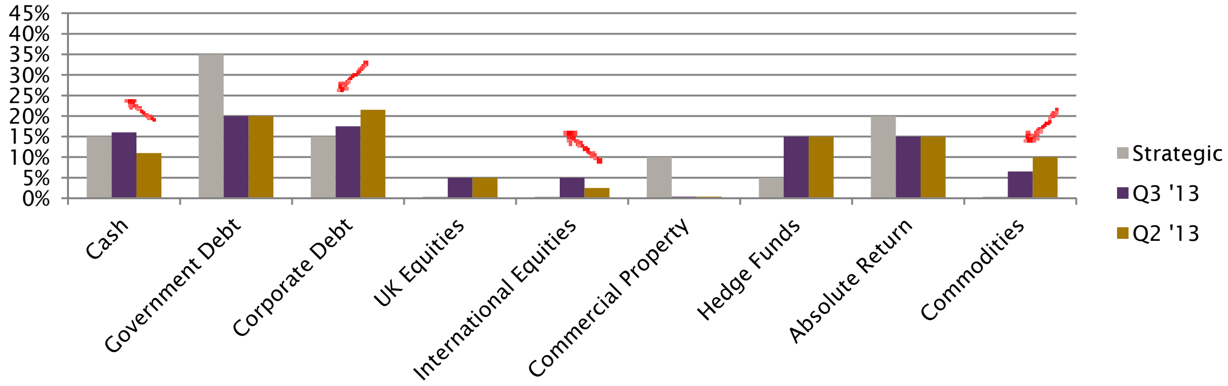
Our prime focus is on the management of client portfolio asset allocations, and as you will be aware the initial building block that we start with in the construction of each client portfolio is one of four strategic asset allocations – Capital Preservation, Cautious, Balanced and Aggressive. These long-term 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 were only relatively minor changes across asset allocations in the 3rd quarter. In all our asset allocations we have:

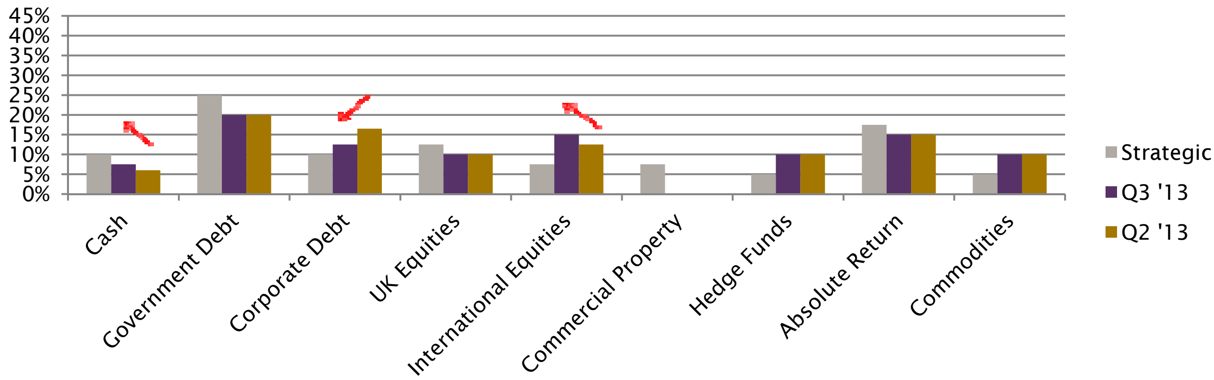
- Increased our cash holdings
- Reduced exposure to corporate debt (emerging markets)
- Selectively increased equity exposure (to Japanese equities)
- Trimmed back our exposure to gold mining companies

The following four charts shows how our tactical asset allocations have changed quarter-on-quarter and also the positioning relative to the longer term strategic asset allocations.

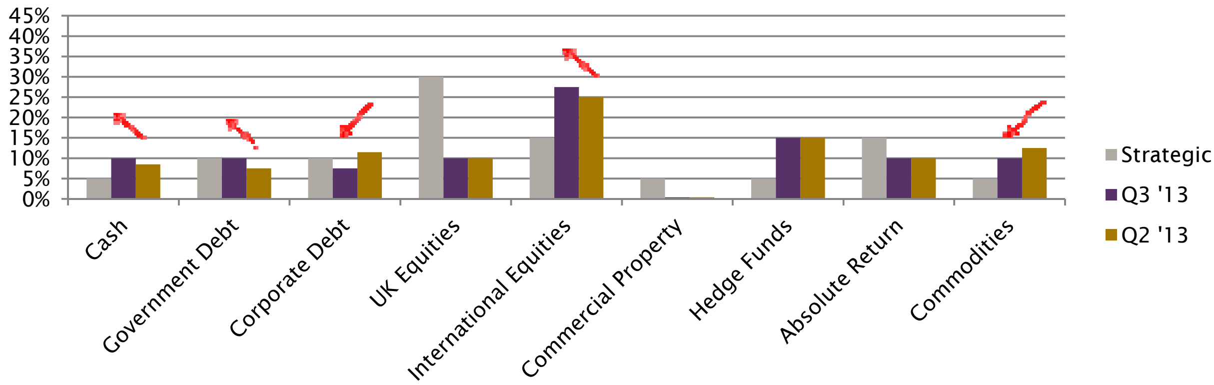
Capital Preservation asset allocation



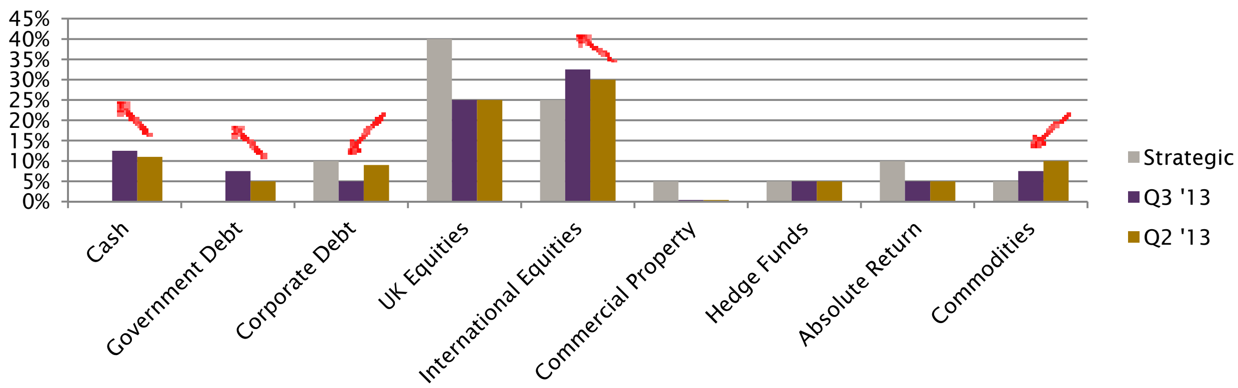
Cautious asset allocations



Balanced asset allocations



Aggressive asset allocations



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

Cash
All of our portfolios hold a weighting in cash to some degree at present and,as everyone will be aware, cash currently offers next to no return. Cash does, however, allow us to take advantage of investment opportunities as and when they arise. Over the quarter we increased cash in all mandates.

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. We see significant upside should the inflation rate in the UK rise from its current level of around 2.8%.

Corporate Debt
We are now underweight on corporate debt exposure for all clients. Our biggest exposure is now via hedged vehicles and we are therefore not taking much interest rate or duration risk.

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. As noted earlier we increased our exposure to international equities over the quarter.

Commercial Property
We are very underweight relative to our Strategic Asset Allocation weightings. Commercial property prices are, over the longer term, correlated to GDP growth and as we expect minimal growth over the next few years we have no property exposure in our portfolios.

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 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 market directionality. Volatility as measured by the VIX remains close to historic lows.

Commodities
We are overweight Gold as an asset class. We did however trim back our exposure somewhat to gold mining shares over the period as macro risks receded. We now have minimal exposure to other industrial commodities due to our concerns about growth rates in Chinese and Asia. We are very positive towards Agriculture over the long-term and therefore have exposure across all 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 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 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 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

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