

## Client Newsletter July 2012

Welcome to the summer edition of the Quartet newsletter. 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

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The second quarter of 2012 has been no less dramatic than the first. Whilst equity markets started the year with a bang and much optimism, the second quarter saw a return to reality for many investors as global worries emerged again. Overall both quarters have been full of drama but ultimately we find stockmarkets back to where we started on the 1 January.

#### FTSE 100 Index (1 April – 30 June)



Source: [londonstockexchange.co.uk](http://londonstockexchange.co.uk)

As we mentioned at the start of the year stockmarkets are likely to remain volatile throughout 2012, and that has certainly proven to be the case over the first six months.

The volatility and uncertainty remains because of the Eurozone's inability to find a resolution to its financial problems. After 19 summits since the start of the crisis, the European heads emerged at the end of June with very little new to announce. Today's problems are yet to be resolved and the bond markets are now severely punishing Spain and Italy with higher borrowing costs as a result.

Added to Europe's troubles have been the growing concerns over a Chinese economy that is slowing at a greater pace than many predicted, and disappointment over the US Fed indicating the money printing presses (QE3) will not be turned on again anytime soon.

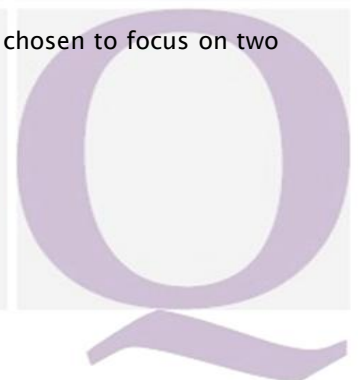
### Outlook

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Looking at the global economy, our main concerns remain. The following issues are to our mind highly relevant and still do not appear to have been adequately addressed by global leaders.

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

We will look to discuss these themes in our letters from time to time but have chosen to focus on two below due to recent developments.



### ■ *Eurozone sovereign debt crisis*

Whilst almost nothing new was officially announced following the Eurozone summit at the end of June, it is increasingly becoming clear that some of the struggling periphery countries (and France!) are beginning to side against Ms Merkel and Germany. Could Germany in fact end up becoming the odd-one-out in Europe and leave?

Whilst the electorate in Germany may be increasingly incensed at the prospects of bailing out the rest of Europe (especially after the recent €100 billion Spanish bank bailout - which doesn't even scratch the surface for the Spanish banks - and Italy now indicating they might need help as well), the simple fact is that the German central bank has much to lose if the Eurozone were to break up.

Under a little known settlement system called TARGET 2 (the interbank payment system for the real-time processing of cross-border transfer throughout the European Union), Germany is presently owed close to €700bn by other European nations. If Germany were to leave the Eurozone, and the Euro disintegrated, the German central bank may well find that much of this money is never repaid! This is a cost Germany simply cannot afford to bear, and it would appear their fellow Eurozone members know this. Ms Merkel is presently stuck between a rock and a hard place and further pressure for more money and bailouts could be applied to Germany over the coming months.

### ■ *Fears over weaker US growth*

The US seems to have dropped off the radar of potential problems for investors in recent months but this is likely to change for several reasons; the presidential election looms in November, another US debt ceiling is quickly approaching and will no doubt lead to much political wrangling again, and investors will very quickly begin to feel the impact from the repeal of several tax breaks Americans have been enjoying. Many commentators have estimated the tax repeal will reduce US growth by over 1%, which would make the current growth rates in the US look rather anaemic.

Overall, given that the Eurozone is fast approaching some form of end-game we believe it appropriate to be cautiously positioned for all portfolios at present. Longer term we are starting to see good value emerge in many asset classes and would describe ourselves as frustrated bulls (i.e. we would like to invest, but just do not feel the time is correct). One such asset class is Agriculture.

## Agriculture

### The protein time bomb

Over the next 20 years the OECD (Organisation for Economic Co-operation and Development) expects the global middle classes to rise by 3 billion people, and part of this will be due to the global mass migration from rural to urban areas.

Both these factors will see an increase in wealth for those making the transition and as people gain wealth they seek better living standards, especially food type. For many this means consuming less grains and more meat, specifically chicken, pork & beef.

To produce every 1kg of extra meat, we need to produce several times this weight in grain, for example 2/3kg for chicken, 4kg for pork, 7/8kg for beef. Globally the result will be unprecedented pressure on future livestock and grain prices.

### China will be a major cause

China has seen an industrial revolution over the last 20 years, and this is continuing at pace - it took the UK 150 years to reach the same stage. Of the OECD's projected 3 billion addition to the global middle class ranks, 1.3 billion are expected to be Chinese.

As China becomes more urbanised, their population's eating habits (as expected) have changed substantially, with food expenditure increasing by nearly 3 times compared to their rural counterparts. It is also interesting to find their meat consumption per head doubled between 1994 and 2009, but this still falls considerably short of the meat consumed by developed countries!

### China's catch 22

China's leadership has long considered food self-sufficiency a matter of national security and has allocated considerable resources to achieving this goal. However, their infrastructure and urbanisation



drive of recent years has caused much crop land to be lost, leading to China becoming a net buyer of grains.

China also has a water problem. Feeding 20% of the global population on only 6% of the fresh water is already difficult, and will only become worse when China's present resources are increasingly directed towards the industrial development they have encouraged.

### It is not just a Chinese problem

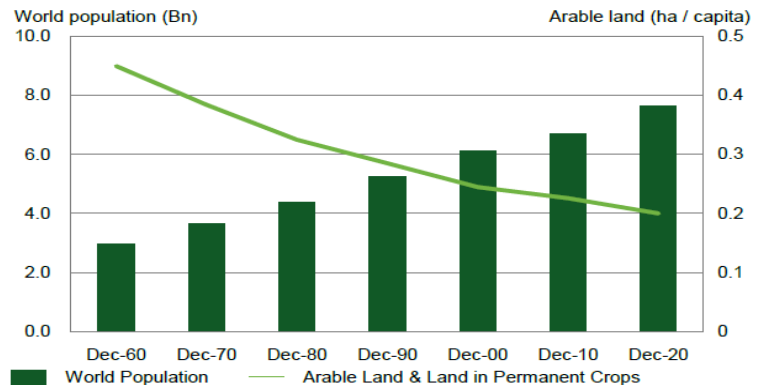
Globally we are losing increasing amounts of arable land to urbanisation, and at the same time the world's population, and middle classes, continue to grow rapidly (see below chart - Source: Laguna Bay Pastoral Company).

With Oil prices near all-time highs the search for alternatives has led to the rapid growth of bio fuels in America and emerging markets, all of which rely on grain.

Arable land is a finite resource, as is fresh water, and the pressure on both these resources will only increase over the coming decades.

Overall, the agriculture investment story is very much one of increasing living standards on a global basis.

The demand for meat will increase, leading to an increased requirement for grains. However, at the same time arable land areas are decreasing, and over the next few decades the demand on existing resources will be immense. The trick is finding the best ways to take advantage and invest for the longer term.



### What does this mean for Quartet's client portfolios?

Our prime focus is on the management of client 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 asset allocations are then tailored to each client's circumstances to create a bespoke client portfolio. Client strategic asset allocations are adjusted on a tactical basis depending upon our economic and investment views.

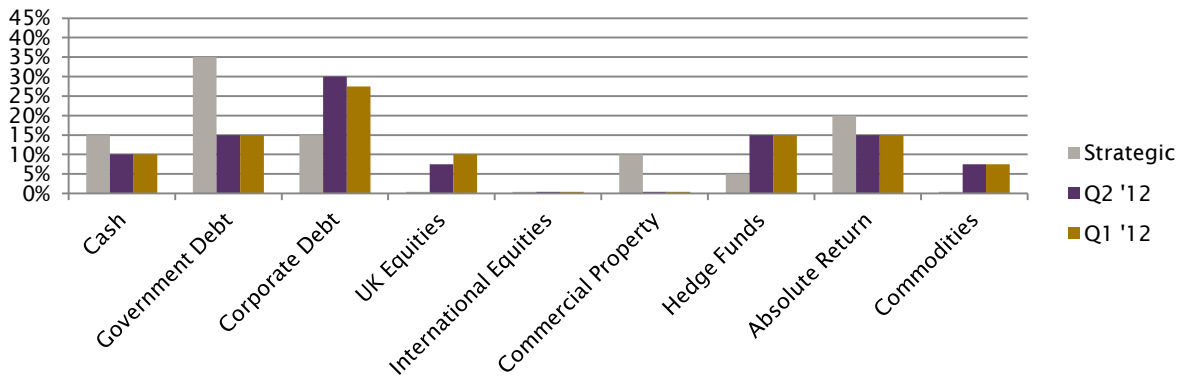
Main actions taken in client portfolios over the past quarter:

- **Capital Preservation:** Due to increased fears of further equity market downside we reduced our UK equity exposure over the quarter. The proceeds were invested in quasi-government emerging market debt where default risk looks low and yields are above 6%.
- **Cautious:** Given equity weightings are already defensively positioned, we did not feel the need to reduce the equity exposure further. We did however use cash to increase our exposure to quasi-government emerging market debt, currently yielding above 6%.
- **Balanced:** Due to our macro-economic concerns we reduced our UK equity exposure modestly. We have decided to increase our hedge fund and absolute return exposure by around 10% to try and benefit from the continued levels of volatility we expect going forward. As with other portfolios we increased our exposure to quasi-government emerging market debt by 2.5%.
- **Aggressive:** As with our Cautious Asset Allocation we maintained the same equity exposure and significantly increased our weighting to quasi-government emerging market debt.

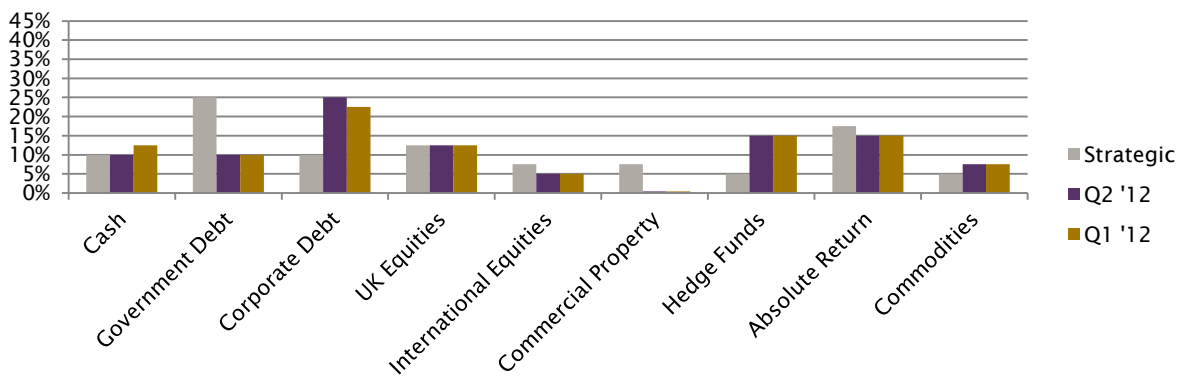
Detailed below are four charts showing how our tactical asset allocations have changed quarter-on-quarter and also the positioning relative to the strategic asset allocations.



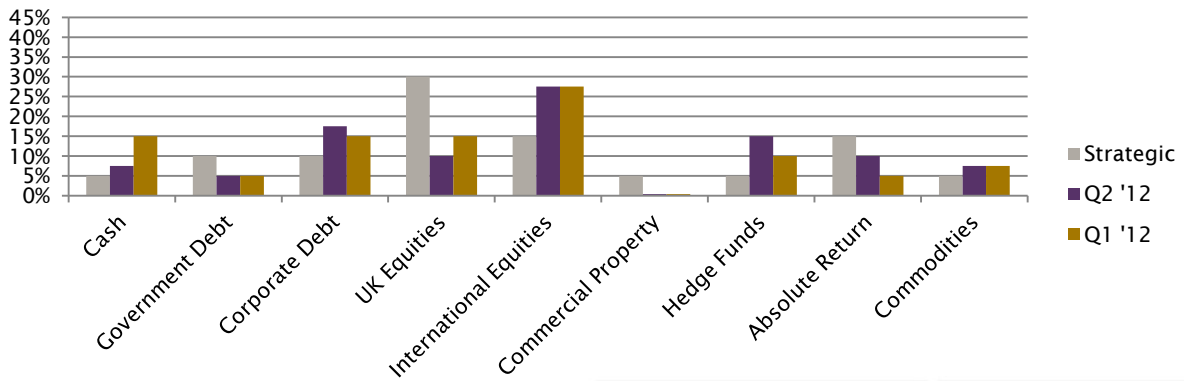
### Capital Preservation asset allocations



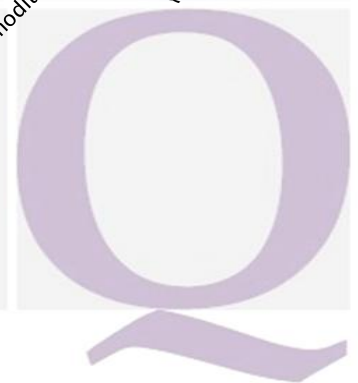
### Cautious asset allocations



### 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 provides next to no return as an investment. Cash does, however, allow us to take advantage of investment opportunities as and when they quickly arise. With yields so low we are not keen to have a large cash position over the medium to long term.

### Government Debt

We are significantly underweight government debt across all portfolios. Whilst we have benefitted from the safe haven status of UK government gilts by holding them over the last few years, the interest yields received if investing now are at all-time lows and generating negative real returns. As a consequence we see little value in this asset class at current levels, especially if the UK loses its coveted AAA status, and a fair amount of potential downside.

### Corporate Debt

In contrast to our government debt exposure we are overweight corporate debt for all clients. Evidence suggests that many companies strengthened their balance sheets following the 2008 crisis and now look in good shape, with interest yields looking both attractive and secure. We expect yield to be a much bigger component of the return going forward for clients and being able to earn an income yield of 5-6% with reduced capital risk is attractive in this environment.

### UK & International Equities

As mentioned earlier in this letter, at the moment we are frustrated bull investors. In other words, we believe there is significant value in specific stockmarkets, both UK and abroad, if you are willing to buy and hold an equity investment for the long term (10 years or more!). However, we are also acutely aware of the many lingering problems (as previously highlighted) in the global economy that mean there could be even better opportunities to invest in the near-term. As a consequence we intend to be patient and seek opportunities, using the available cash, as they present themselves over the coming months.

In general we are underweight equities as a whole for portfolios. The only exception is for our Capital Preservation clients, which are marginally overweight UK Equity exposure, as a result of our longer term desire to have a modicum of equity exposure in the portfolios given the attractive yield on offer compared to other asset classes.

### 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 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. An example of this would be that approximately 60% of Absolute Return active managers produced a negative performance in 2011.

### Commodities

In general 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 commodities due to our long held belief that the Chinese and Asian economies will slow significantly this year.

Alternatively, we are very positive towards Agriculture over the long-term (please see earlier in the letter) and would expect exposure to be built up across all risk mandates over the coming months.

### News

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We are very pleased to announce that a second Quartet baby has now been introduced to the world, and Colin has become the very proud father of his first daughter; Amelia.



## 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 confidential meeting with Quartet, please contact either Colin McInnes ([cgm@quartetcapitalpartners.com](mailto:cgm@quartetcapitalpartners.com)) or Nigel Olliff ([njo@quartetcapitalpartners.com](mailto:njo@quartetcapitalpartners.com)) via email or on (020) 8939 2920.

## Quartet Capital Partners LLP

July 2012

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