Client Newsletter July 2015

Welcome to the second Quartet newsletter of 2015. 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 half year

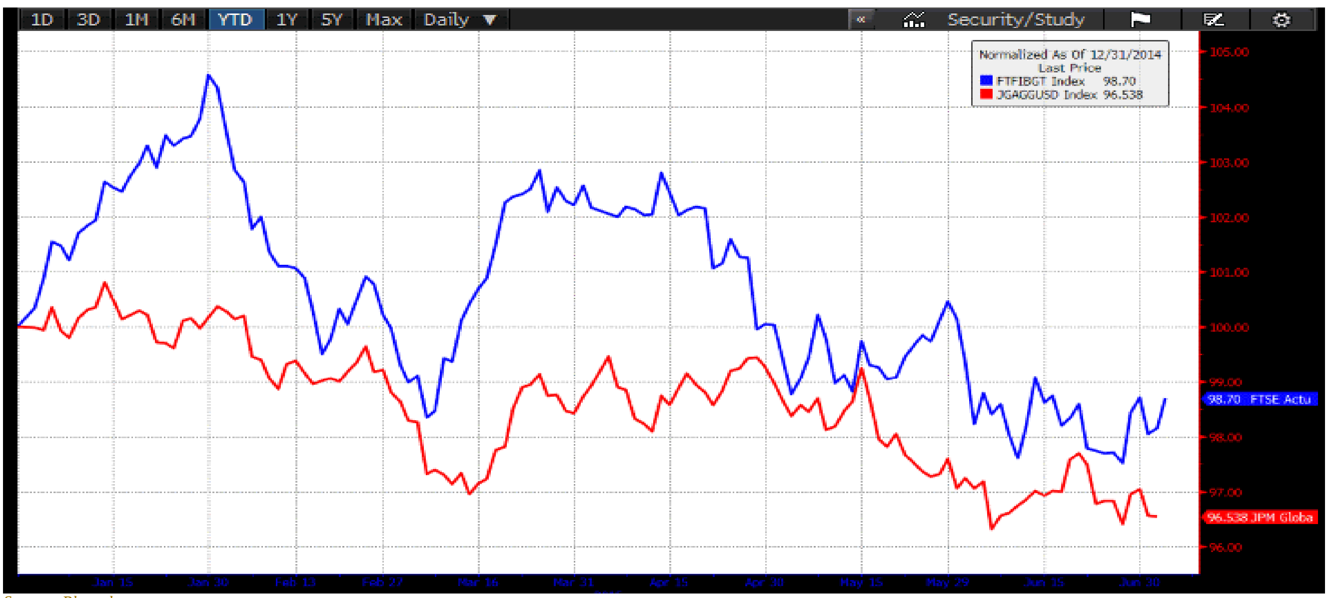
Over the first 6 months of 2015, the UK stockmarket has been range bound with the FTSE 100 unable to maintain its break above the 7,000 level. UK equity markets experienced a strong start to 2015 but struggled in June, falling by over 3%. However, due to the strong start to the year the FTSE 100 index ended the first half of the year in positive territory.

FTSE 100 Index (31 December 2014 – 30 June 2015)

Source: Portfolio Sharing

The Bond Market (31 December 2014 – 30 June 2015)

The chart below shows the UK (blue) and US (red) government bond indices during the first half of this year. We have selected these two markets because they reflect two economies that are experiencing a relatively decent recovery, and where interest rates are most likely to rise in the near future. As can be seen Government bonds have had a tough first half falling by 1.3% for the UK and 3.46% for the US.



Source: Bloomberg

Outlook

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

- Eurozone sovereign debt crisis, particularly what happens in Greece
- Slowdown in Asia, especially China
- Global credit deleveraging
- Rising interest rates

Given that these macro issues have been known for some, time in this newsletter we will instead focus on Risk and what it really means to us here at Quartet.

Volatility is many people's choice for defining and measuring risk. In essence, the more volatile the investment the more risky, or unpredictable, it is perceived to be. To our mind this does not make sense. Whilst volatility is quantifiable and can be a measure of the riskiness of an investment it does not define what risk is.

Investopedia Explains 'Volatility':

Commonly, the higher the volatility, the riskier the security. In other words, volatility refers to the amount of uncertainty or risk about the size of changes in a security's value. A higher volatility means that a security's value can potentially be spread out over a larger range of values. This means that the price of the security can change dramatically over a short time period in either direction. A lower volatility means that a security's value does not fluctuate dramatically, but changes in value at a steady pace over a period of time.

In thinking about risk, are we really concerned about volatility? To a degree; yes. However we rarely think about whether the prospective return from an investment is justified based on its volatility. What we are really concerned with is the possibility of **permanent loss**.

Permanent loss is very different to volatility. A downward move in value does not concern an investor if one is able to hold on and come out the other side. Permanent loss obviously does not enjoy a rebound in value and can occur when a fall is crystallised via selling or the actual investment is unable to recover any of its value. Ultimately one can ride out volatility but never overcome permanent loss.

Unfortunately the probability of permanent loss is not measureable. It can be modelled and estimated but it cannot be known.

Investing requires us to decide how to position a portfolio for future developments where the future is not known. We believe the future should be viewed, not as a fixed outcome, but rather a range of potential outcomes with us assigning a probability to each. If we knew for certain what was going to happen there would not be any risk.

Logic says that riskier investments need to offer investors the possibility of higher returns. However the eventual outcome is less secure and may well fare worse than a low risk investment.

To reduce the risk of losing capital when investing, we look to diversify your investment portfolio across a range of investments, some low risk and some high risk, to help reduce your overall investment risk. So, if one investment performs poorly over a certain period, other investments may perform better over that same period, reducing the overall losses in your investment portfolio.

For example, during periods of increased stockmarket volatility, share prices may fall. If one also holds investments in other asset classes such as fixed interest or property that may perform better over the same period, the returns from these investments will help to smooth the returns of your overall investment portfolio. So, by diversifying your investments we are trying to achieve more consistent investment returns over the medium to longer term.

....but it only works when you get the asset allocation right.

The asset allocation of your individual portfolio is determined by your risk tolerance level and financial goals, which in turn are influenced by your age, investment time horizon and liquidity needs.

Investopedia Explains 'Risk Tolerance'

The degree of variability in investment returns that an individual is willing to withstand. Risk tolerance is an important component in investing. An individual should have a realistic understanding of his or her ability and willingness to stomach large swings in the value of his or her investments. Investors who take on too much risk may panic and sell at the wrong time.

Investors can assess their degree of risk tolerance by taking one of a number of different risk tolerance questionnaires. In addition, it can be useful to review worst-case returns for different asset classes historically in order to get an idea of how much money one would feel comfortable losing if his or her investments have a bad year or bad series of years. Other factors affecting risk tolerance are the time horizon that one has to invest, future earning capacity, and the presence of other assets such as a home, pension, social security or inheritance. In general, one can take greater risk with investable assets when there are other, more stable sources of funds available.

We seek to meet clients individual risk tolerance by constructing individual bespoke portfolios. Within a portfolio there will be a mix of what would be defined as higher risk investments as well as lower risk ones. The balance of the two will be determined by how aggressive, from a risk standpoint, the client wishes the portfolio to be. For example in lower risk mandates we will tend to have fewer investments where the risk of permanent loss is high and vice versa for high risk mandates.

What does this mean for Quartet's client portfolios?

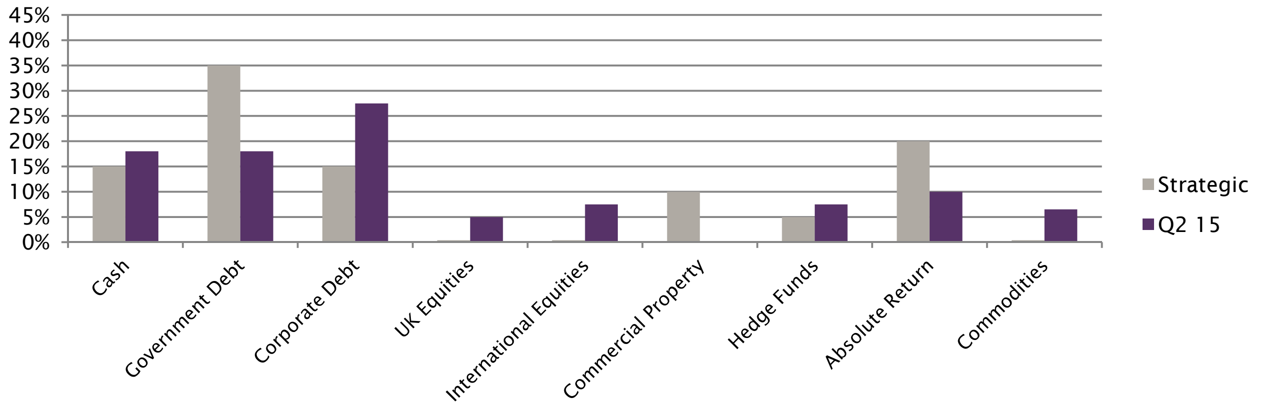
Our prime focus is on the management of client portfolio asset allocations, and as you will be aware the initial building block that we start with in the construction of each client portfolio is one of four strategic asset allocations as defined by the following risk profiles – Capital Preservation, 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 minor changes across risk profiles in the 1st half of 2015 where we have:

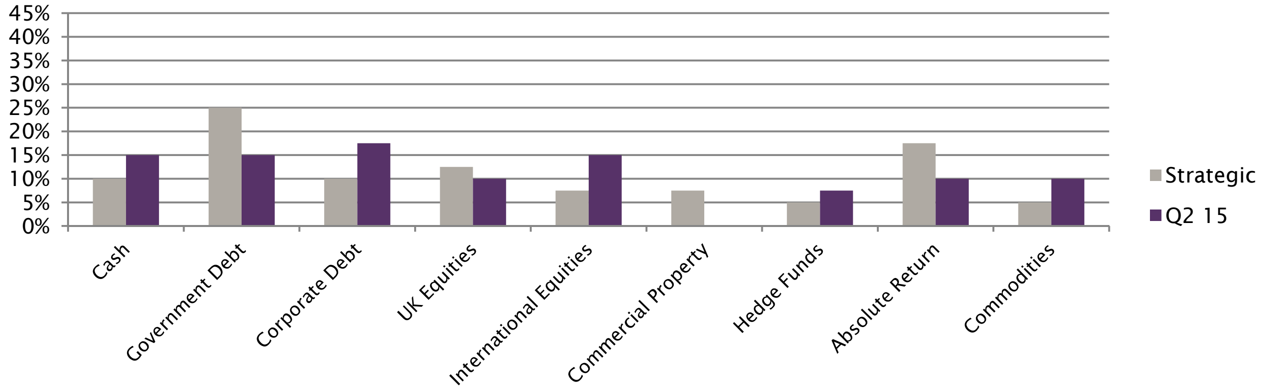
- Marginally reduced our equity exposure by taking some profits on our highly profitable Japanese equity position.
- Slightly increased our corporate fixed interest exposure for balanced accounts as, whilst we believe interest rates will probably rise next year, the rise will be small and hence not have much impact on bond prices.
- Restructured much of our alternative asset exposure to ensure correlations amongst asset classes remain low.
- Increased exposure to the US$ via a position in US TIPS (inflation-protected US government bonds).

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

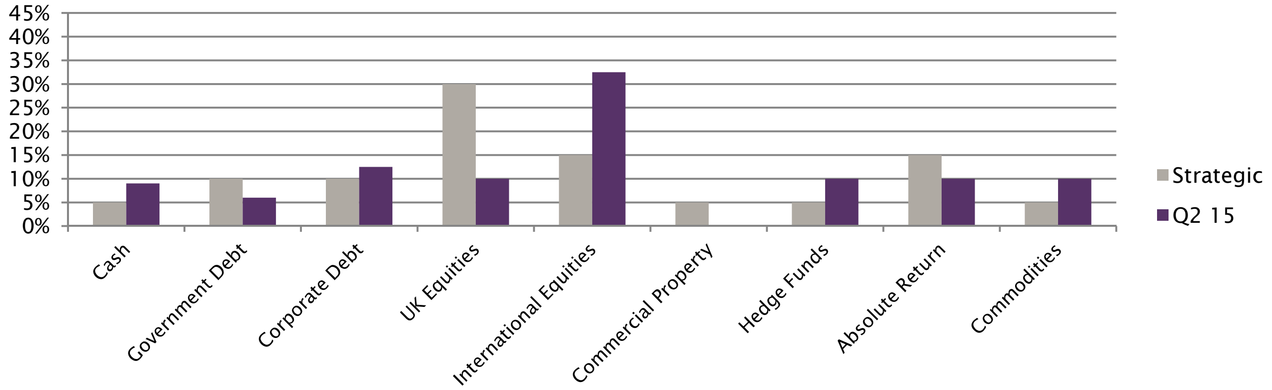
Capital Preservation asset allocation



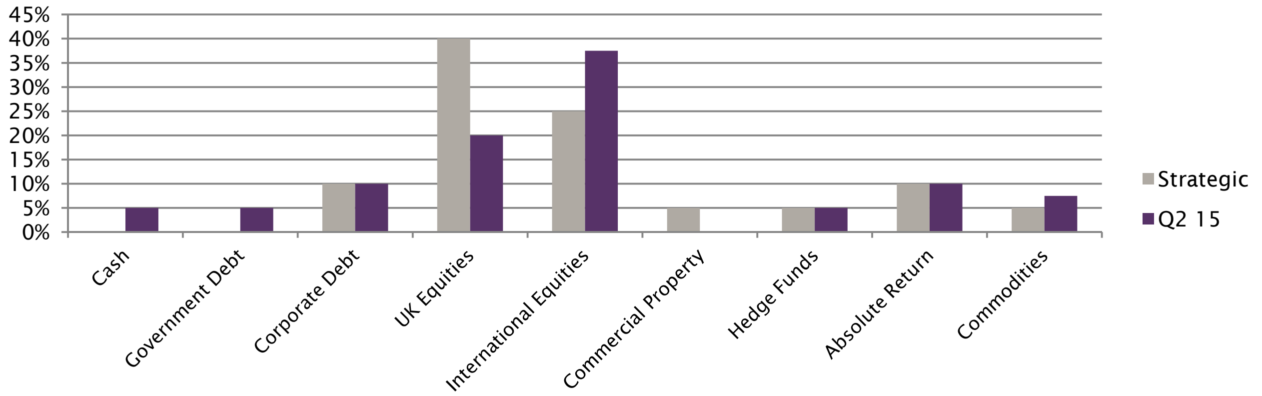
Cautious asset allocations



Balanced asset allocations



Aggressive asset allocations



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

Cash
Given our macro concerns and the impact the recent events in Greece will have on global markets we are overweight Cash across all portfolios. We expect to deploy this should opportunities present themselves.

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.

Corporate Debt
We are now underweight conventional corporate debt exposure for all clients for the same reason we are underweight Government debt. Our overall overweight position is the result of large exposure to hedged debt vehicles 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. We expect to increase our European equity exposure further in the coming weeks as opportunities present themselves.

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 will remain in the short-term (China is actually down 30% in July!), 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 are neutral weighted towards Gold as an asset class. We now have minimal exposure to other industrial commodities due to our concerns about growth rates in Chinese and Asia. However 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 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 Colin McInnes (cgm@quartet-im.com) via email or on (020) 8939 2920.

Quartet Investment Managers

July 2015