

Client Newsletter Quarter 2 2013

Welcome to the second 2013 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

Global financial markets have had a rollercoaster second quarter with most asset classes, especially Gold and UK Gilts, suffering falls.

FTSE 100 Index (31 March – 30 June)



USD Gold (31 March – 30 June)



UK Gilts (31 March – 30 June)



Source: londonstockexchange.co.uk

As can be seen several major asset classes correlated on the downside which is the ultimate expression of the “risk-off” trade. What sparked this sell off was a speech the Federal Reserve chairman, Ben Bernanke, gave in May 2013 to Congress which many market participants interpreted that interest rates would rise and Quantitative Easing would be reined in. Quantitative Easing, or the Federal Reserve’s strategy of buying up Government bonds and mortgage-backed securities to drive down long-term interest rates makes it relatively inexpensive to borrow, especially for banks, institutions and

private companies. When interest rates are low, investors tend to invest more in equities and other financial assets that are relatively high risk, high reward.

Even though high-risk, high-reward assets have performed well since QE3 was announced in September 2012, since Bernanke's speech in May such assets have struggled.

What makes this whole situation unusual is that interestingly, Government bonds, which are usually considered to be one of the safest assets one can hold, have also been experiencing headwinds. The logic for this is probably the view that Government bonds will be the first to be adversely affected when the Federal Reserve (or other central banks) changes monetary policy, exiting its current QE strategy. This expectation has been reflected by the recent rise in long-term interest rates.

One of the Federal's Reserve's priorities has been to support the housing market in the U.S. and this has been largely successful so far. Much of the QE program has therefore been focused at the long end of the yield curve as most mortgages in the US are long-term in nature and priced off the 30-year Treasury yield. 30-year mortgage rates in the US have risen by 1% since Bernanke's hawkish comments in May, and his subsequent speeches have sought to reverse this movement, with marginal success. The outstanding stock of government debt far exceeds central banks' capacity to buy (via QE) so the relationship between central banks and financial markets hinges on psychology and sentiment so communication is key, and we feel that Bernanke may have stumbled a little in May.

Outlook

As we continue to highlight, many concerns remain for the global economy. Whilst some 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. Again we would like to start by making some comments on the growth in China and then will comment on the recent sharp fall in the Gold price.

Slowdown in China?

China's footprint has become increasingly important for the global economy, as it has grown in size and share. China is now responsible for about 13% of global economic activity compared to 5% in 2006 according to the Wall Street Journal.

China has recently reported an increase in GDP of 7.5% year-on-year for the second quarter following on from 7.7% in quarter one. However the Chinese authorities use a hybrid GDP deflator to produce their real growth numbers. If this was stripped out and one just looked at nominal GDP, nominal GDP **fell by 5.2%** from the first quarter of 2013 and rose by just 1.2% year-on-year. Given the size of China's economy this has important implications for global growth going forward.

Whatever is the real cause for China's nominal GDP to be so weak and should it be troubling to the authorities?

China's new leadership is in a difficult place. Under Premier Li, policymakers are trying to move away from a credit-backed growth model, fostering domestic demand and value added exports to achieve a more sustainable economy. They have stressed their willingness to tolerate lower growth to achieve their goals of clamping down on the shadow banking system, causing a dangerous liquidity squeeze that threatens to spill over to the broader economy.

Should Beijing be worried about political unrest?

Firstly, China's economic slowdown is, in part, a consequence of demographic changes sweeping the country. The downward shift in China's economy neatly mirrors the decline in the country's working-age population -- there were 3.5 million fewer people of working age in the country in 2012 than there were in 2011, a far cry from a decade ago when this figure increased annually. As a result, the economy can slow without a corresponding rise in unemployment. Unemployment, more than anything else, is what Beijing fears can trigger political unrest.

Secondly, a GDP slowdown may help Beijing tackle some of the structural problems with the economy, once described by former Premier Wen Jiabao as "unbalanced, uncoordinated, and unsustainable". A slowdown can help tackle a number of issues that threaten China's long-term health - income inequality and environmental issues being two of the bigger ones - as well as mitigate the country's looming bad debt issues.

If anything, a bigger risk to political stability in China is an economic collapse rather than a gradual slowdown. A cataclysmic financial crisis perhaps caused by the popping of China's housing bubble - that resulted in the depletion of investor savings - could unleash far more public anger than a slight drop in GDP growth.

China's economic growth over the past few decades has been stellar. Not only did China help carry the global economy during the recent financial crisis, along with many of its emerging market peers, but it has continued to deliver some of the strongest growth numbers. Its potential remains incredible, particularly as the middle class begins to emerge and consume.

In the long term, of course, political dissent threatens the Chinese Communist Party. But for now, the idea that China has to maintain 8 percent growth to survive doesn't apply and everybody else who has relied on China to be the global engine may just have to get used to that. Investors should remain cautious as risks and shocks in China, particularly given leverage in the shadow banking system, remain large.

Gold

The gold price has fallen sharply in recent weeks, and this has been shock to a number of investors (us included!). However, gold is, like most commodities and currencies, notoriously volatile so these large price movements are part of life in the world of commodity and currency investment.

Gold serves a very particular purpose in our clients' portfolios. Our view is that it provides an efficient insurance policy against unforeseen events, whether they are related to acts of terrorism or further breakdowns in the financial system. The nature of any insurance contract is that you need to be insured at the time of the event, otherwise the policy won't pay out. With gold, we need to be invested at the time of the event; otherwise we miss the sharp rise in the price. It is for this very reason that we retain our Gold exposure.

The sources of demand for gold can be broadly broken down into three camps:

- Jewellers
- Investors, who hold gold either as a dowry (particularly in India) or as gold bars held in a safe
- Speculators

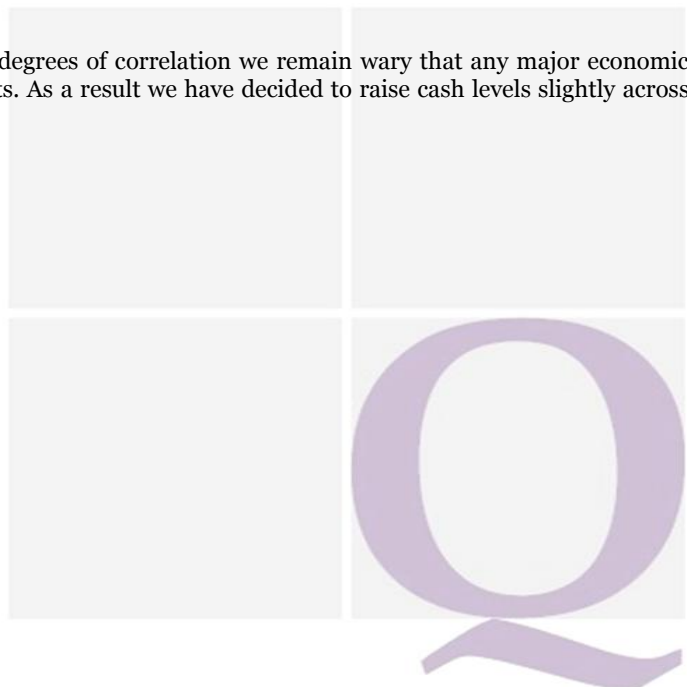
Most speculators will buy and sell gold depending on their views on inflation, interest rates, or currency devaluation (which is usually achieved by "printing" money).

Ben Bernanke, chairman of the Federal Reserve in the U.S., has been hinting at in recent months at a reduction in the supply of money (manifested through Quantitative Easing, or "QE") if the US economy continues to improve. All markets sold off heavily when Bernanke's recent announcement clarified this view. Gold, which is perhaps the purest expression of financial markets' perception of the supply of money, fell much further than equities or bonds.

We feel that markets over reacted to the prospect of the withdrawal of QE. Recent economic data in the US and the UK has been revised downwards, which reflects our view that economic growth remains fragile. We are not therefore overly concerned about the withdrawal of QE, and feel that gold is unlikely to fall much further. Importantly the cost of mining gold is between \$1,000 and \$1,200, so supply is likely to fall if gold remains at current levels. This should be supportive of gold in the long-term, but we are in no doubt that financial speculators have the upper hand in the current environment.

To reiterate our position on gold, we do not hold it for speculative gain but as in insurance policy for capital preservation.

As highlighted earlier, with asset classes showing high degrees of correlation we remain wary that any major economic event may have a significant negative impact on markets. As a result we have decided to raise cash levels slightly across all client portfolios.



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.

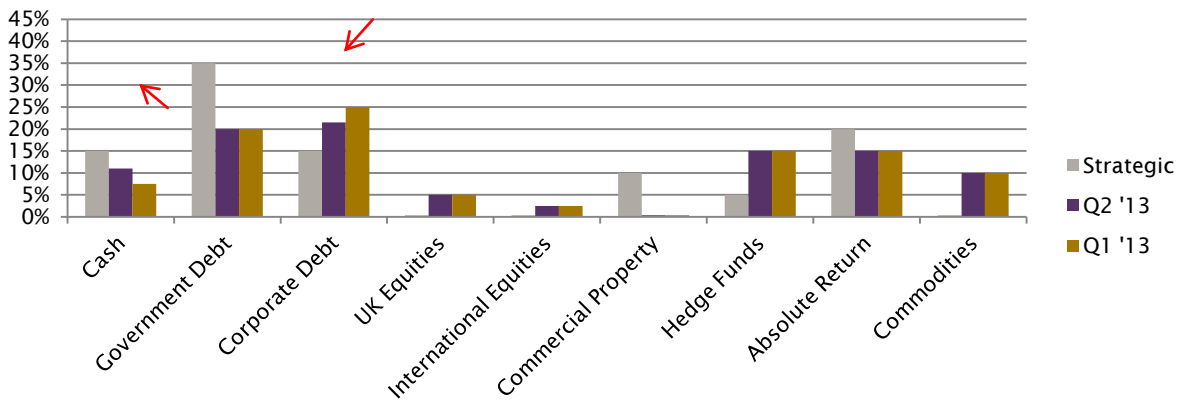
There was little change across asset allocations over the second quarter. The main actions taken are as follows:

- **Capital Preservation:** Due to spreads narrowing we took some profits and reduced our emerging market bond exposure holding the proceeds in cash.
- **Cautious:** We increased our exposure to index linked government debt whilst taking profits on some of our emerging market bond exposure. We trimmed some of our hedge fund exposure and invested the proceeds into Japanese equities.
- **Balanced:** As with Capital Preservation portfolios we reduced our emerging market bond exposure holding the proceeds in cash.
- **Aggressive:** Once again we reduced our emerging market bond exposure holding the proceeds in cash.

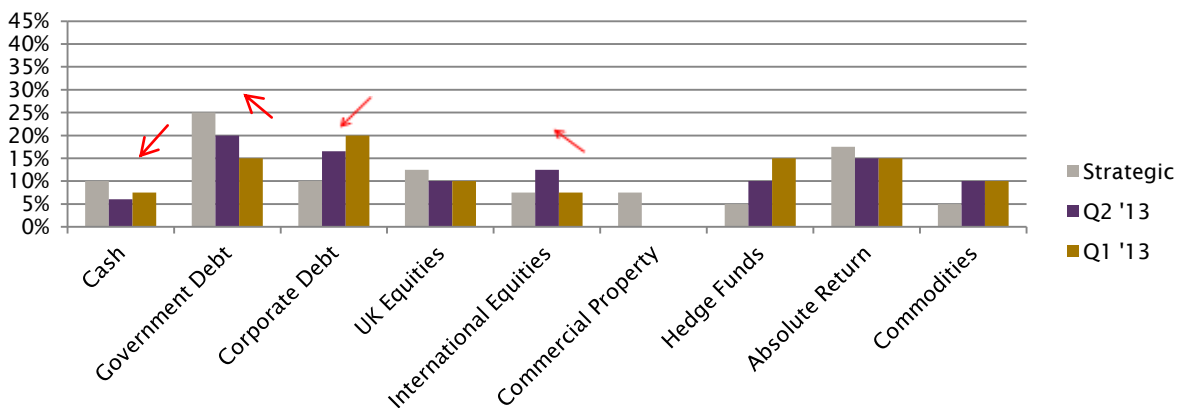
Detailed below are four charts showing how our tactical asset allocations have changed quarter-on-quarter and also the positioning relative to the strategic asset allocations.



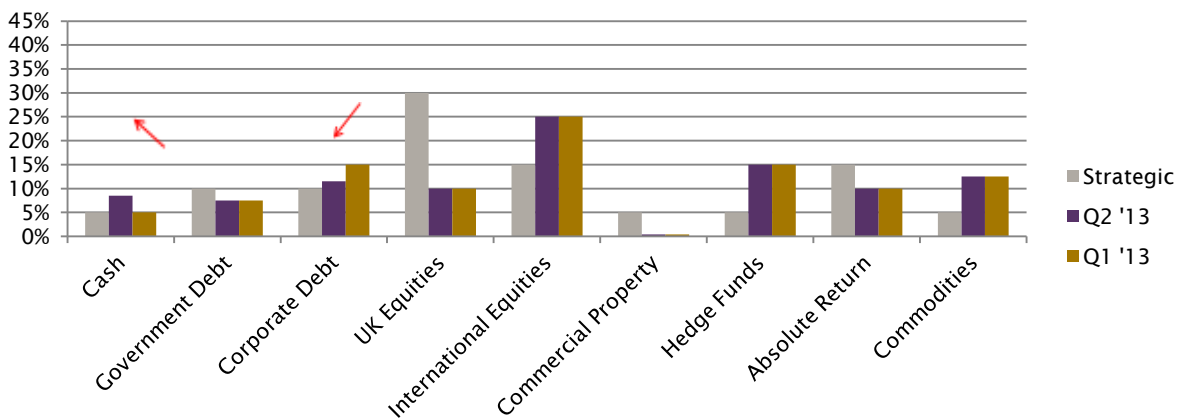
Capital Preservation asset allocation



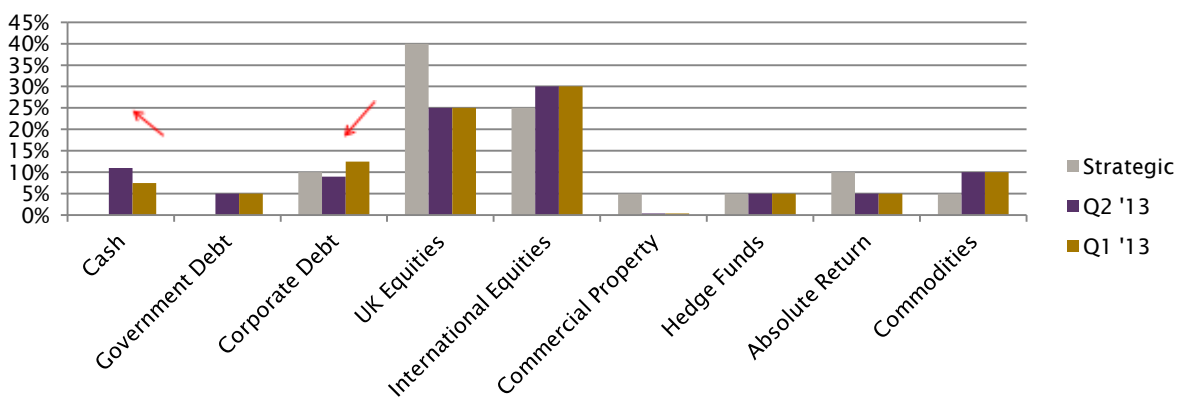
Cautious asset allocations



Balanced asset allocations



Aggressive asset allocations



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 most 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 broadly neutral overall on corporate debt exposure for all clients. This does however mask the fact that much of our 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 continue to see value in equity markets if one is willing to buy and hold equities for the next 10 years or more! However, short-term we remain wary.

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

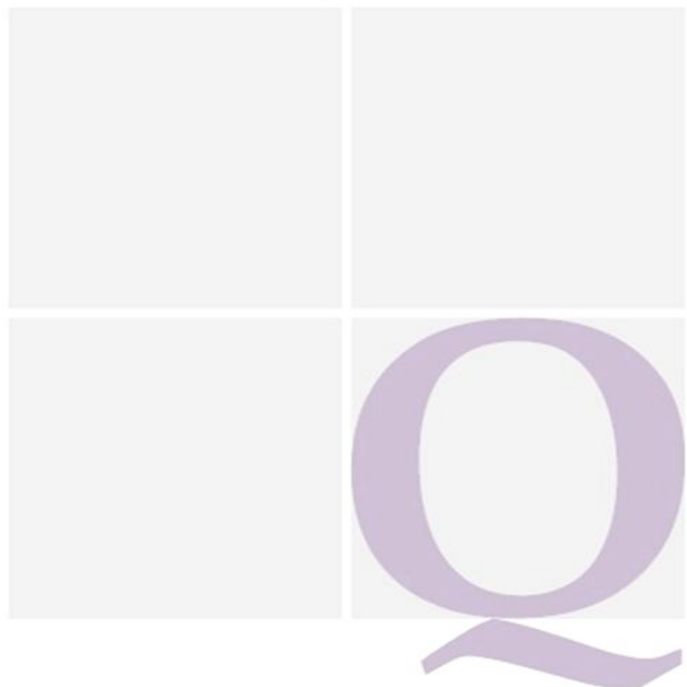
As the Eurozone problems rumble on, volatility and directionless markets will remain in the short-term, and in this kind of environment we would expect this asset class to perform well. Across all portfolios we are neutral to overweight on a tactical basis.

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, which we discuss earlier. 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 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 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

July 2013

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