

## Client Newsletter January 2015

Welcome to the first 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.

Unlike previous newsletters, we plan to review 2014 in terms of investment markets as well as what we got right and wrong in portfolios. We will then look into our crystal ball and detail how we are positioned going into 2015 and the reasons why.

### Review of 2014

#### Equities

There were mixed performances across global equity markets in 2014. The UK equity market was the worst performer of the major markets falling by just over -2.5% during the year.

#### FTSE 100 Index (31 December 2013 – 1 January 2015)



Source: Portfolio Sharing

In contrast the S&P 500 in the US rose by 11%, the EuroStoxx 50 in Europe rose by 1% and the Nikkei 225 in Japan rose by 7%. Were it not for the rebound in global equity markets enjoyed in the latter half of December, last year would have turned out a lot worse than it did.

In part, we got our positioning right by being underweight the UK in favour of Japan and Emerging Markets (excluding Russia). We did, however, miss out on some of the strong performance of US equities as we remained neutral throughout the year, with a 5% allocation.

#### Bonds

Few would have predicted that the 30 year bull market in bonds would have continued in 2014. With interest rates predicted to rise, the consensus opinion in January last year was to sell government bonds. Instead, European government bonds rose 13% and in the US by 5%. UK index-linked bonds did even better, returning over 18%!



Source: Bloomberg

Whilst we had no conventional government bond exposure our biggest position across Quartet was in both UK and US index-linked bonds which finally came good.

## Currencies

2014 was the year of the US Dollar, which strengthened significantly relative to other major currencies. A year ago US\$:£ rate was 1.66 and is now sub 1.56 and the US\$:Euro rate has fallen from 1.38 to 1.21.

### British Pound to US Dollar (31 December 2013 – 1 January 2015)



Source: Portfolio Sharing

The newfound strength of the US dollar makes perfect sense. It is a reflection of today's reality: the U.S. is the lone bright spot among the world's major economies. GDP growth is now above 3% and that is why the Federal Reserve has concluded its long-running economic stimulus program known as quantitative easing which, by pumping huge quantities of dollars into global financial markets, was one factor behind the US\$:£ weakness in recent years. Meanwhile, most of America's key trading partners like Europe and Japan are heading in the opposite direction as their economies struggle with deflation and low growth.

Thankfully in 2014 we had been calling dollar strength relative to sterling, with most clients benefitting from dollar exposure of anywhere between 10% and 20%, depending on their risk profile.

## Commodities

2014 was a terrible year for almost all commodity markets. Here we got most of our calls wrong. Agriculture did poorly due to good weather and a bumper wheat harvest. We also retained a small position in gold, held as disaster insurance, which struggled. Thankfully both positions are denominated in US Dollars which spared us most of the pain (the charts below are priced in US Dollars so do not reflect the currency benefits for sterling-based investors).

### Crude Oil (WTI) (31 December 2013 – 1 January 2015)



Source: Portfolio Sharing

### Gold (USD) (31 December 2013 – 1 January 2015)



### Outlook for 2015

#### Quantitative Easing in Europe coming soon....

Deflation appears to have taken hold in the Eurozone. Falling oil prices over the past six months exacerbated the situation and there is mounting pressure on the European Central Bank to tackle the problem by implementing a program of Quantitative Easing (QE).

QE is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to encourage lending and enhance liquidity.

The implications of QE for financial markets are a weaker Euro, support for government bond prices and ultimately, due to lower borrowing costs, a potential catalyst for the start of economic growth and a rise in European equities.

#### Volatility in equity markets to rise

The low levels of volatility seen in equity markets over the first half of 2014 is not expected going forward. We expect further divergence in the economic policies of governments and central banks so we think the spikes seen in the second half of 2014 will happen more frequently and hence the journey for equity markets will be bumpier. This should create greater opportunity to buy assets at more attractive valuations.

### CBOE Volatility Index (31 December 2013 – 1 January 2015)



## Equity markets

As discussed in our July 2014 Newsletter, the returns on equities depend a lot on where equity valuations are when you actually invest. At current valuation levels it is, in our opinion, risky to buy US equities. Whilst not seeking to predict future US equity returns, we are simply pointing out that prospects for future gains in the US equity market are much lower at current P/E multiples than they are at more normal levels. In this regard, valuation measures may not be a good timing tool but rather a good risk-measuring tool.

Our view that the US stock market is “overvalued”, may be more correctly stated as it is more expensive than it has typically been in the past. Over its history, the U.S. stock market has offered, on average, an expected total return of circa 8% per annum. Now, in our opinion, it’s priced for 5% or 6% and there are many reasons why, looking forward, the present US stockmarket is unlikely to produce the circa 8% returns that it has produced, on average, throughout history. As a consequence we are underweight US equities in our long term strategic asset allocation.

For equities generally it is in this environment that yield, or income, becomes even more precious, and we believe that income will provide a higher proportion of the total return from equities in the years ahead. We will, however, need to be more discriminatory about the ability of companies to sustain current levels of dividends as deflation, or falling prices, can reduce the level of distributable profits. Certain sectors, such as oil and supermarkets, spring to mind.

In light of all this, we start 2015 marginally underweight equities versus our longer term strategic weightings across the risk profiles. However, the hunt for yield will more than likely result in a higher equity allocation as 2015 evolves and we seek to capture income at sensible valuations, and in sectors that promise stable or growing dividends. Infrastructure is attractive in this respect, so we may look to initiate exposure in that sector in the near future.

Within our equity exposure we remain overweight emerging markets and Japan relative to the US and UK. At some point we expect to increase our allocation to European equities as they appear to be the most out of favour with investors, while the European Central Bank is likely to embark on its own program of “QE”, which could provide an extra boost to asset prices in the region.

## Bond markets

After strong performance in 2014, government bonds offer minimal returns going forward and whilst we do not envisage interest rates rising in the UK anytime soon, they may do so in the US towards the back end of the year given the more favourable economic outlook. In any case, with government bond markets still subject to central bank interference via “QE” we expect government bond yields to remain relatively stable in the short-term.

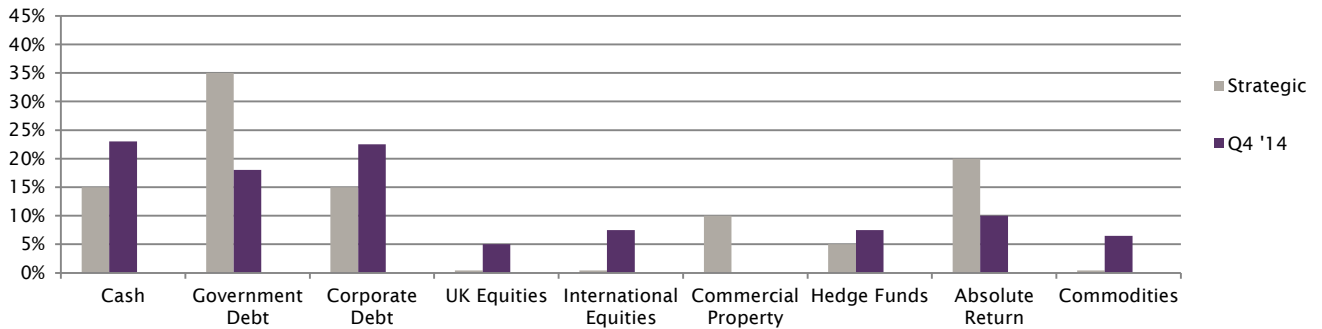
Inflation is not currently a threat to bond investors. Wages remain depressed in the developed world, and without higher incomes and lower debt levels, consumers are unlikely to have the confidence to materially increase spending, even if the oil price has fallen -60%. Deflation will, therefore, dominate for the time being.

In an environment where government bonds offer little or no return, “alternative” bond funds present a more compelling strategy for investors, so we are likely to retain our bias to investments that can extract more esoteric returns from an otherwise unattractive asset class.

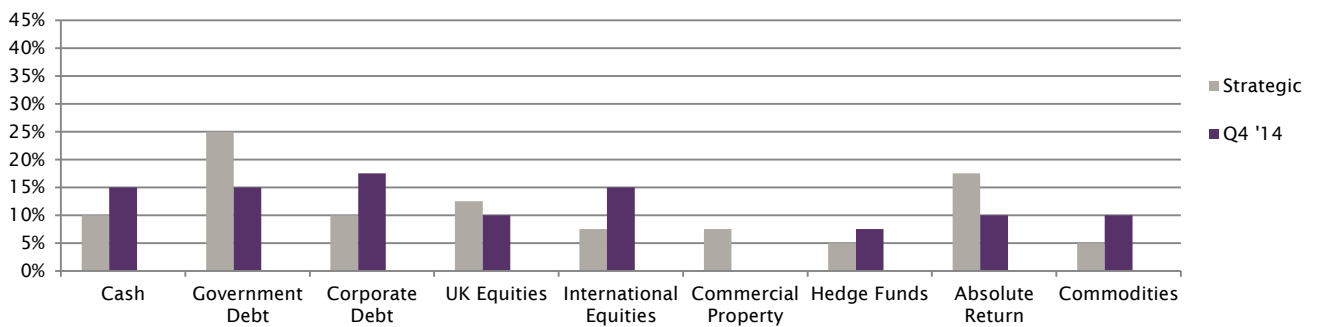
## What does this mean for Quartet’s client portfolios in 2015?

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 asset allocation. Client strategic asset allocations are adjusted on a shorter-term tactical basis depending upon our economic and investment views. The following four charts show how our current tactical asset allocations differ from the longer term strategic asset allocations.

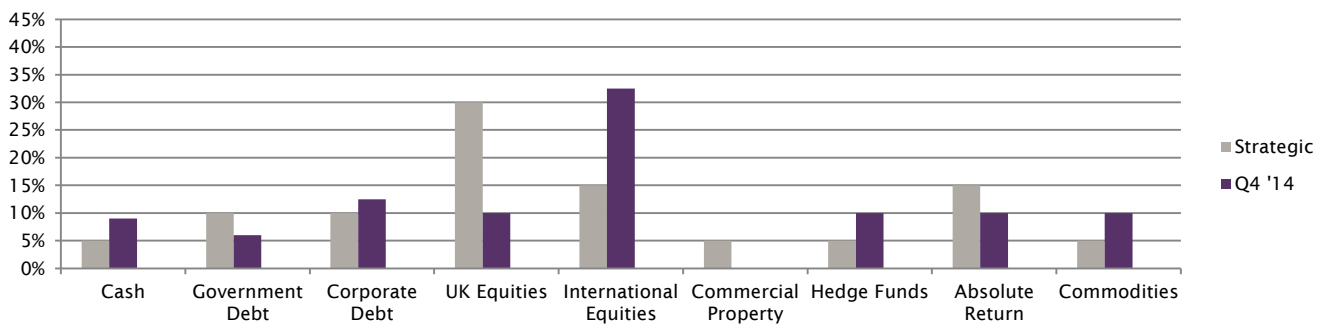
### Capital Preservation asset allocation



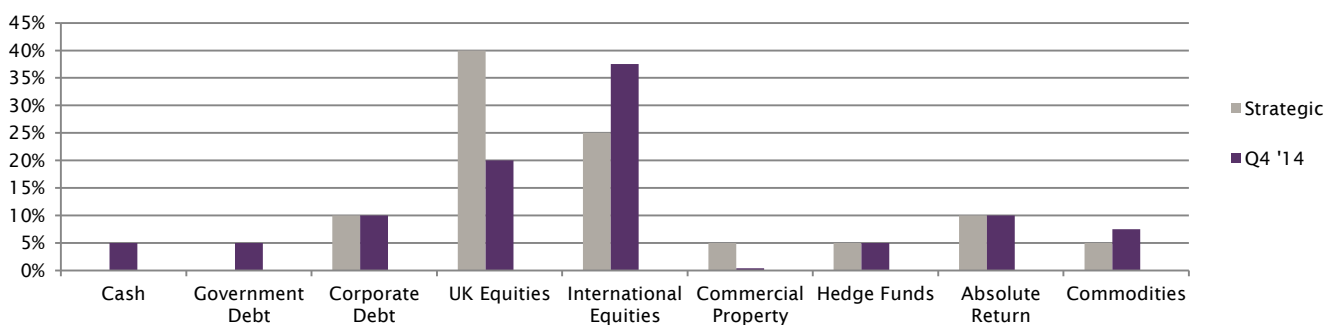
### Cautious asset allocation



### Balanced asset allocation



### Aggressive asset allocation



## **Comments on the differences between our current and strategic asset allocation positioning**

### **Cash**

We are currently holding more cash in portfolios than normal. This is primarily as a result of us taking profits on our index-linked bond exposure. We envisage spending this cash over the coming weeks as market volatility presents opportunities, with a current expectation of allocating to European infrastructure.

### **Government Debt**

We are significantly underweight conventional government debt across all portfolios and retain our preference for index-linked government bonds in the UK and to some degree in the US. Following the very strong performance enjoyed by index-linked debt in Q4 of last year we have almost halved our exposure and are now underweight our longer term strategic allocation. We see limited upside from current levels.

### **Corporate Debt**

We are now underweight conventional corporate debt exposure for all clients. Our overall overweight position is the result of large exposure to hedged, or “alternative”, 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 remain positive on Japanese and Emerging Market equities. We would also expect to increase our European equity exposure should the market continue to fall.

### **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 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 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 China and Asia. However, we remain very positive towards Agriculture over the long-term and therefore have exposure across all client portfolios. Should oil continue to struggle we may initiate some exposure here but this will not be for the faint-hearted.

## **Conclusion**

The Chinese curse "may you live in interesting times" pretty much sums up 2014 with the oil price crashing and Russia going into free-fall. Market turbulence has continued into 2015 with the latest being triggered by events related to the Swiss Franc exchange rate. Capital preservation is high on our list of priorities so we therefore continue to be cautious with our asset allocations for all portfolios.

## A reminder of what we do

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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.

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](mailto:cgm@quartet-im.com)) via email or on (020) 8939 2920.

## Quartet Investment Managers

January 2015

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