

Client Newsletter January 2016

Welcome to the first Quartet newsletter of 2016. 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 second half of 2015, the UK stockmarket has had a much tougher time than the 1st half, falling by circa 4.5%. UK equity markets experienced a strong start to 2015 and peaked in mid-April. Never did the saying “Sell in May and go away” prove more apt. As a result the FTSE 100 delivered a negative return over the course of 2015.

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



Source: Portfolio Sharing

The FTSE 100 index has been the worst of the major equity indices in recent times and it is the only major market to fall in both 2014 and 2015. This poor performance might seem strange given that the domestic economy has been relatively healthy and that the political situation now looks reasonably stable following the UK general election in May. However, in reality the FTSE 100 is quite an international index that has been dragged down by London listed global resource shares.

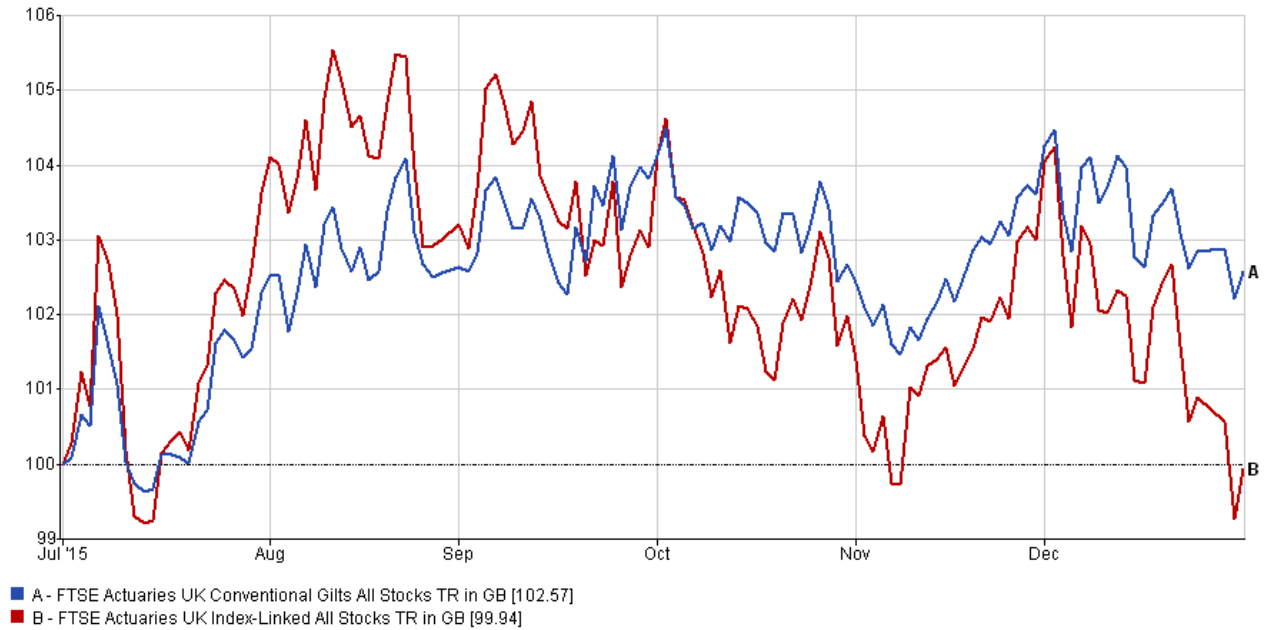
The S&P 500 index failed to make it back into positive territory for the full year. This performance would have been even worse had it not been for a small number of very strongly performing technology related stocks. The broader US market struggled to maintain earnings growth momentum and energy stocks had a particularly bad year. The big news last quarter was that the Federal Reserve Bank has finally raised interest rates – the first increase since 2006.

As often seems to be the case, Japan was not entirely in step with the other major developed markets this year and the Nikkei index was the best performing market for both the final quarter and the year, finishing in positive territory.

With US interest rates rising, a slowdown in China and further weakening of the commodities cycle, emerging markets remained firmly out of favour with investors and the MSCI Emerging Markets index was down by 20% in 2015, making it three years in a row of negative returns.

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

The chart below shows the UK Gilts (blue) and UK Index Linked (red) government bond indices during the second half of last year. The divergent performance over the period, with conventional Gilts outperforming and delivering positive performance, reflects the view that interest rates in the UK are not likely to rise in the short term.



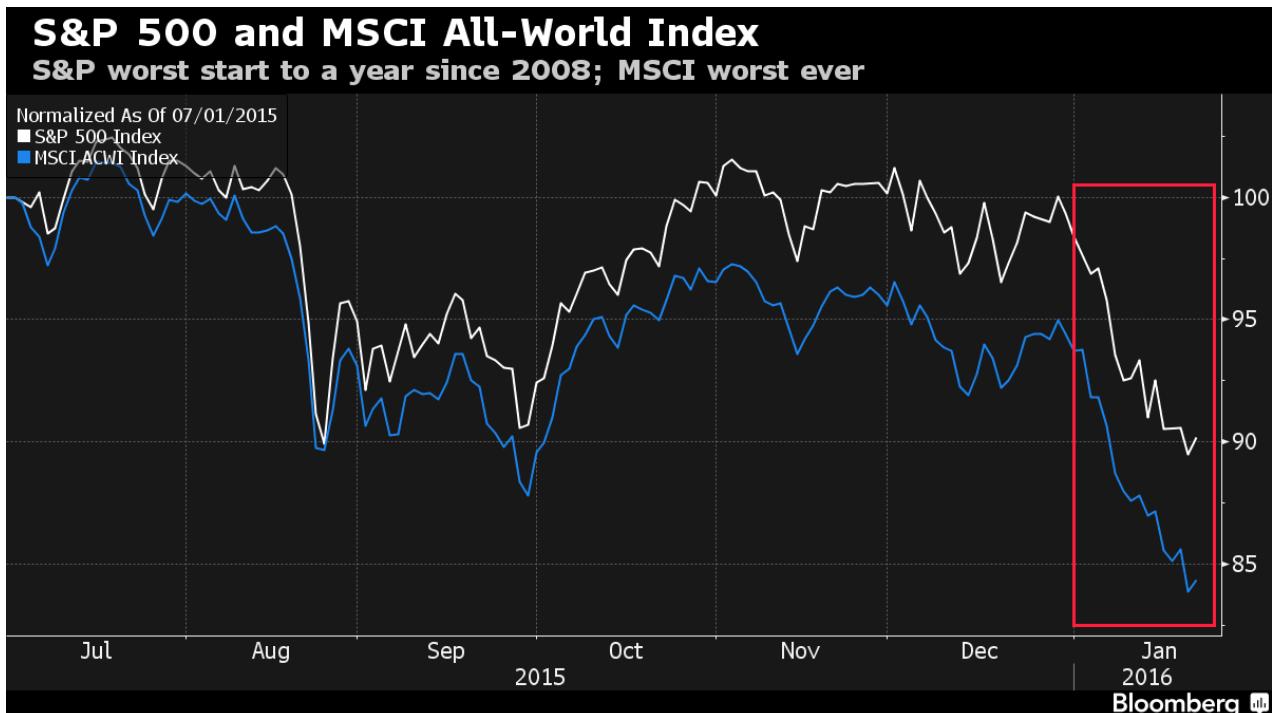
01/07/2015 - 31/12/2015 Data from FE 2016

Source: FE Analytics

Corporate bond markets began to suffer from the threat of deflation during the latter part of 2015. In the absence of rising demand, falling prices mean falling revenues for companies, and this has been most extreme in the commodity sector in recent months. With the oil price falling by 42% during the second half of 2015, investors became fearful that some energy companies might not be able to pay the interest on their borrowings, so the High Yield bond market sold off sharply.

Outlook

We have been shocked by how badly markets have started 2016, as I am not sure that anyone could have predicted the speed and ferocity of the year-opening falls.



Whilst some of the factors driving markets are not major surprises, certainly the reaction that there has been, is.

We view much of what has occurred at the start of 2016 is mainly due to a change in investor sentiment - from positive to negative – which has caused some investors to sell “risk assets” indiscriminately. Two principal factors have caused this rapid change in investor sentiment: first a slowing Chinese economy. China is not growing at 6-7% per annum as suggested by official sources; neither is it growing at the 1-2% level that some of the more pessimistic estimates suggest, but probably at 3-4% (China only makes up 12% of global GDP so we do not view this as a major crisis). Secondly, a sharply falling oil price. Whilst this causes problem for producers a falling oil price causes problems in the Middle East where sovereign wealth funds have been sellers of liquid assets to plug budget spending gaps, consumers all over the world are major beneficiaries, so there are winners and losers.

We certainly do not predict a global crisis (as Royal Bank of Scotland recently has). Note there have only been two major global crises in the last 100 years (1929 and 2008), so they don't occur that often!

The direction and pace of global GDP growth is primarily determined by two economies; the US and China. Unfortunately, due to problems in both, the medium term global investment outlook is becoming increasingly uncertain. There is now a growing risk that the ongoing emerging market bear market fully envelops developed markets as well. US equities face a maturing business cycle, a growing risk that the Fed may have to rapidly tighten monetary policy, stretched corporate balance sheets and high valuations. At the same time, in China, the slowing economy and the ever increasing opacity of policymaking clouds the growth outlook for the whole of Asia, the emerging markets asset class and the world in general.

Unfortunately while there is, even amongst this gloom, still scope for significant upside, the path of the sources of this upside – Chinese policymaking and the raw power of excess global liquidity – are almost impossible to predict with any confidence. Trying to pre-empt them, given the current elevated level of equity market valuations, is fraught with downside risk.

As a result we expect equities to continue to struggle in the short-term, but expect them to find a floor close to current levels. It is hard to see a sharp rebound in equity markets given weak global growth and the retraction in global trade. Some markets are better value than others, and we continue to favour Japan and Europe – at least in the short to medium term - and this is reflected in our overweight allocations to both. We remain underweight the US given much higher valuations and a strong US dollar, but in the long run, demographic factors will ensure that the U.S. economy will continue to have strong growth. We expect an improvement in emerging market equities as we think the majority of the damage has been done already. Our conclusion is that equities are at the top end of fair value but certainly, ex-US, we are happy with our exposure in portfolios.

Government bonds have offered some stability during January, with our Index-Linked Gilt investment rising by over 2%, so we are pleased to see a return to negative correlations between the main asset classes. With the threat of rising interest rates receding in the current fragile environment, bonds should continue to do relatively well, although riskier areas of the corporate bond market require investors to be highly selective in their sector allocations. We think that a number of energy companies are likely to default on their debt obligations in the months ahead causing some problems for the high yield debt market, particularly in the US.

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.

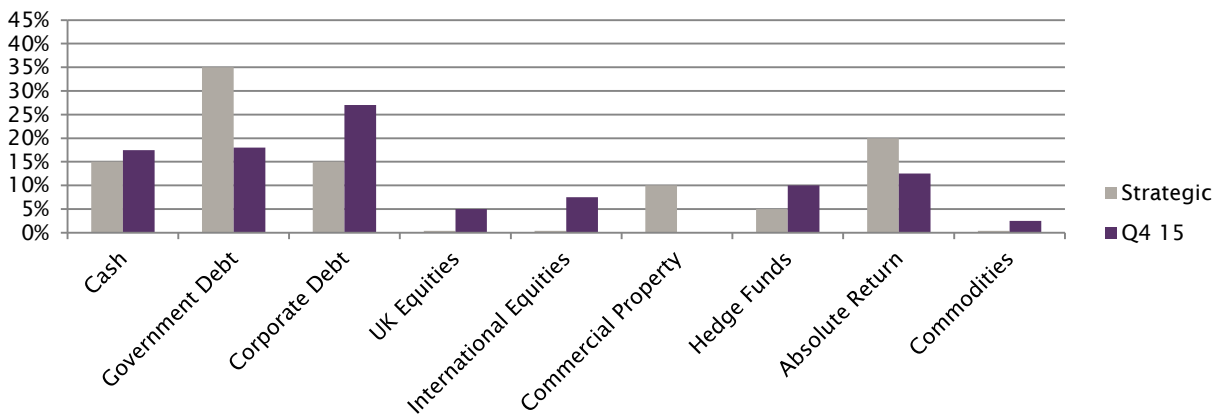
There have been changes across risk profiles in the 2nd half of 2015 where we have:

- Increased our European equity exposure following the sharp sell-off in equities in August.
- Finally sold our holding in Gold (perhaps prematurely) as it was no longer acting as our “disaster insurance” across portfolios.
- Slightly increased our corporate fixed interest exposure for balanced accounts to capture some more yield.
- Restructured much of our alternative asset exposure to ensure correlations amongst asset classes remain low.

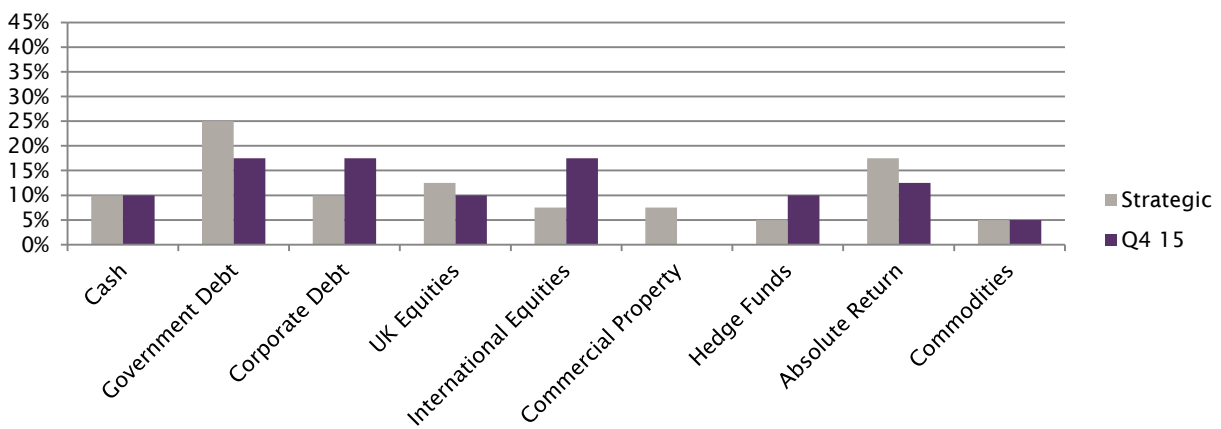
In conclusion we remain underweight equities for the time being, and believe we have enough foreign currency exposure (mainly US dollars) to provide effective diversification and protect against the possibility of continued weakness in sterling given the weak economic environment and the prospect of a Brexit (which is unlikely, but will affect sentiment).

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

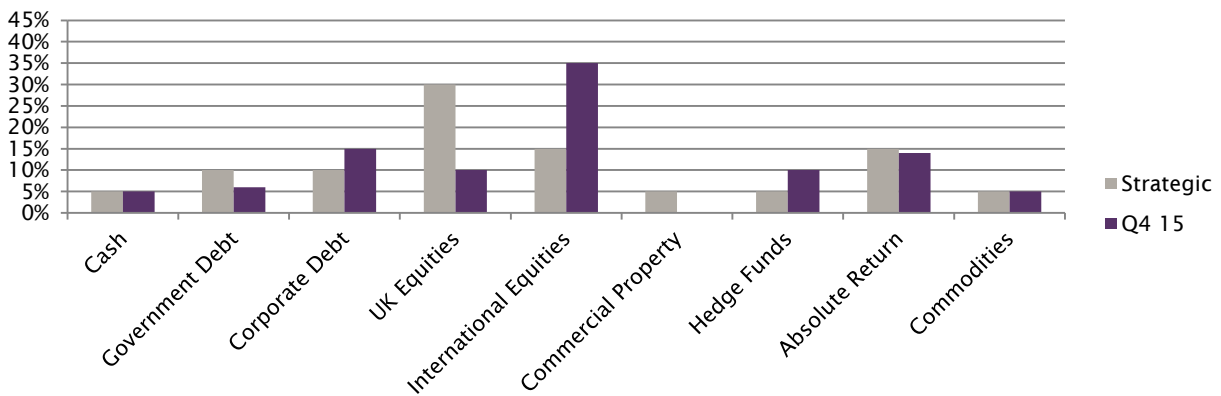
Capital Preservation asset allocation



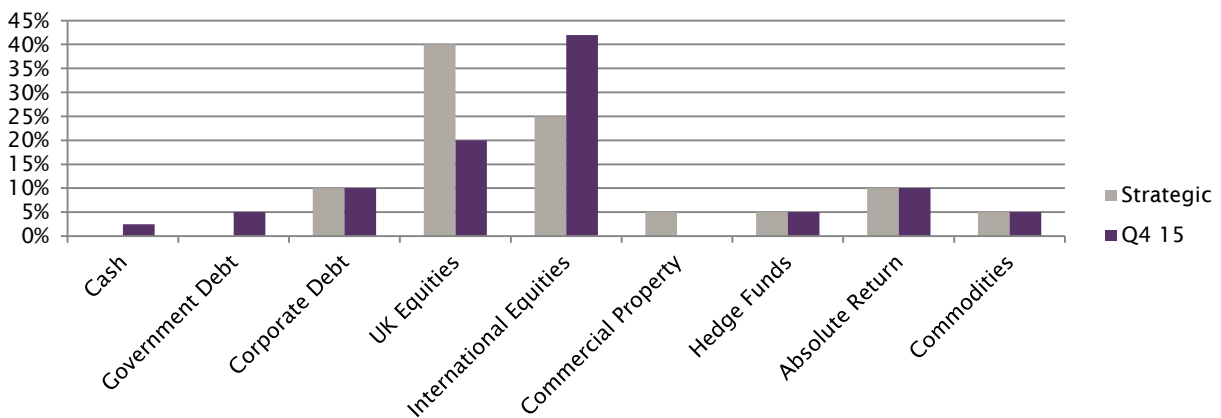
Cautious asset allocation



Balanced asset allocation



Aggressive asset allocation



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

Cash

Given our macro concerns and the current state of equity markets we are neutral to slightly overweight Cash across all portfolios. We expect to deploy this should opportunities present themselves. Note that in the past few days we have increased our cash position significantly following the ongoing troubles in markets.

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. In addition their performance is negatively correlated to equity markets in a downturn providing portfolios with some downside protection.

Corporate Debt

We are now underweight conventional corporate debt exposure for all clients for the same reason we are underweight Government debt but 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. As an aside we have in the past few days sold down one of these hedged vehicles as we see limited upside over the coming year for its strategy.

UK & International Equities

We remain underweight the UK versus overseas where we see better opportunities. As highlighted earlier we continue to favour Europe and Japan at the expense of the US where we think valuations are more stretched.

Commercial Property

We currently have no exposure to Commercial Property across portfolios. Commercial property prices are, over the longer term, correlated to GDP growth and as we expect minimal growth over the next few years we think there is limited capital upside.

Hedge Funds

As the Eurozone problems rumble on, volatility 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 long term market directionality.

Commodities

We now have minimal exposure to other industrial commodities due to our concerns about growth rates in Chinese and Asia. However we remain 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 Quartet's Managing Partner, Colin McInnes (cgm@quartet-im.com), via email or on (020) 8939 2920.

Quartet Investment Managers

January 2016

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