

Client Newsletter July 2014

Welcome to the first Quartet newsletter of 2014. 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

The UK market has been range bound over the past six months with the FTSE 100 unable to break through the 7,000 level

FTSE 100 Index (31 December 2013 – 30 June 2014)



Source: Portfolio Sharing

UK equity markets experienced a volatile start to 2014 but rose in the second quarter. However because of the weak start to the year the FTSE 100 index has not quite made it back into positive territory. Contrary to most people's expectations, 2014 has so far been good for bonds with yields falling against a backdrop of subdued inflation and moderate growth.

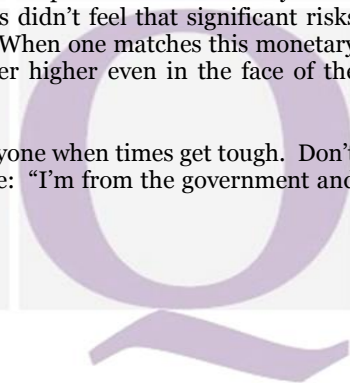
Outlook

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.
- Fears over weaker US growth.
- Slowdown in Asia, especially China.
- Global credit deleveraging.

Given that these macro issues have been known for some time in this newsletter we will instead focus on equity markets, their current valuations and our expectations going forward. As highlighted in previous newsletters we have been concerned about the foundations on which this stock market rally has been based, i.e. interest rates at historic lows and quantitative easing. These monetary actions by the authorities may have been a sensible response to extraordinary times but they are not without risk and interest rates would not be this low if central banks didn't feel that significant risks persist. This substantial stimulus program has almost certainly distorted asset prices. When one matches this monetary state of affairs with equity volatility measures at lows and stock markets moving ever higher even in the face of the troubles in Ukraine, Syria and Iraq, investors should be more wary than they are!

Investors have come to believe that the government and central banks will bail out everyone when times get tough. Don't forget the famous Ronald Reagan quip that the most dangerous words in the world are: "I'm from the government and I'm here to help".

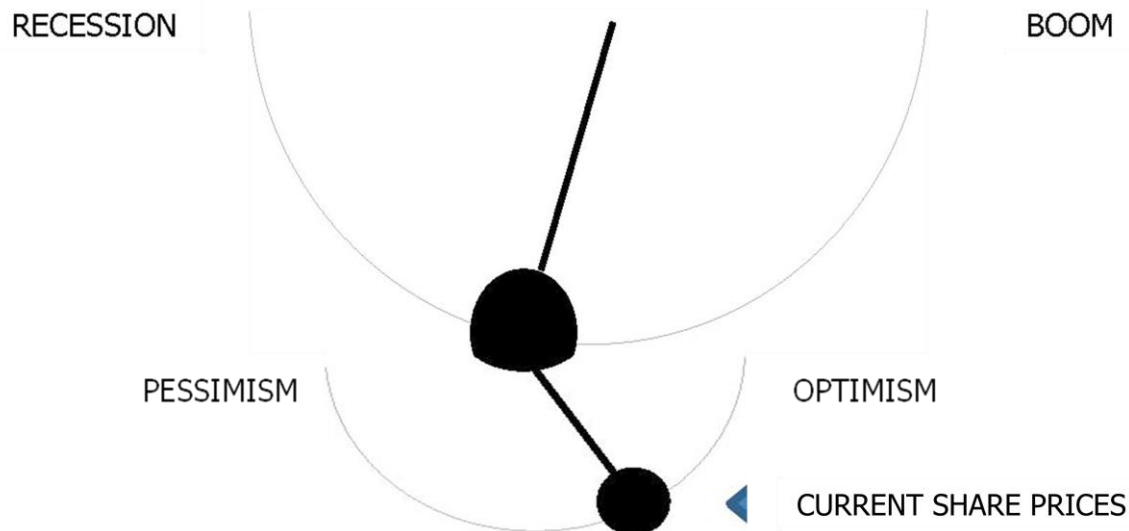


Equity markets

Economies never remain constant and whilst Gordon Brown famously predicted that he had ended the cycle of Boom and Bust he found out in 2008 that this was not quite the case. As a result one can think of an economy as vacillating between Boom times and Recessions.

The motion of a pendulum is a useful model for this thinking as it swings from boom to recession and back again passing through a point of equilibrium. Because of the momentum it builds it always passes through equilibrium and over to the other side before that same force pulls it back again.

Phoenix Asset Management provides a conceptual model of how share prices behave by adding a second pendulum i.e. a pendulum with another pendulum hanging from it. The upper pendulum represents the broader economy whilst the lower one represents the swing of investor sentiment from Optimism (bullish) to Pessimism (bearish).



The upper pendulum is big and heavy (the economy) and its motion is not too affected by the smaller ‘investor sentiment’ pendulum hanging off it. The overall motion is a combination of the slow steady swing of the upper (economic) pendulum combined with the bottom (investor sentiment) pendulum swinging more quickly.

Right now in the UK and the US we think that the economic cycle is heading from recession towards equilibrium (the big pendulum), but that investor sentiment (the small pendulum) has passed equilibrium and is firmly into optimism, if not euphoria. The diagram shows that position. Optimism in the UK and US stockmarkets is high. New company listings (IPO’s) are being rushed to market and informed and unforced sellers like private equity firms rarely sell cheaply.

If our contention is that the broader economy in the UK and US is improving whilst investor sentiment is approaching euphoric levels, what are our expectations for stockmarket returns going forward?

Looking at history, the stock market’s returns depend a lot on where equity valuations are when you actually invest. Ned Davis Research in the US has compared the actual levels of the S&P 500 Index each month with a “normal” valuation of the index based on fundamental factors like P/E, dividends, earnings, and cash flows. They identified points when the US market was over or undervalued by at least 20% and they calculated the market’s performance *after* each of these points.

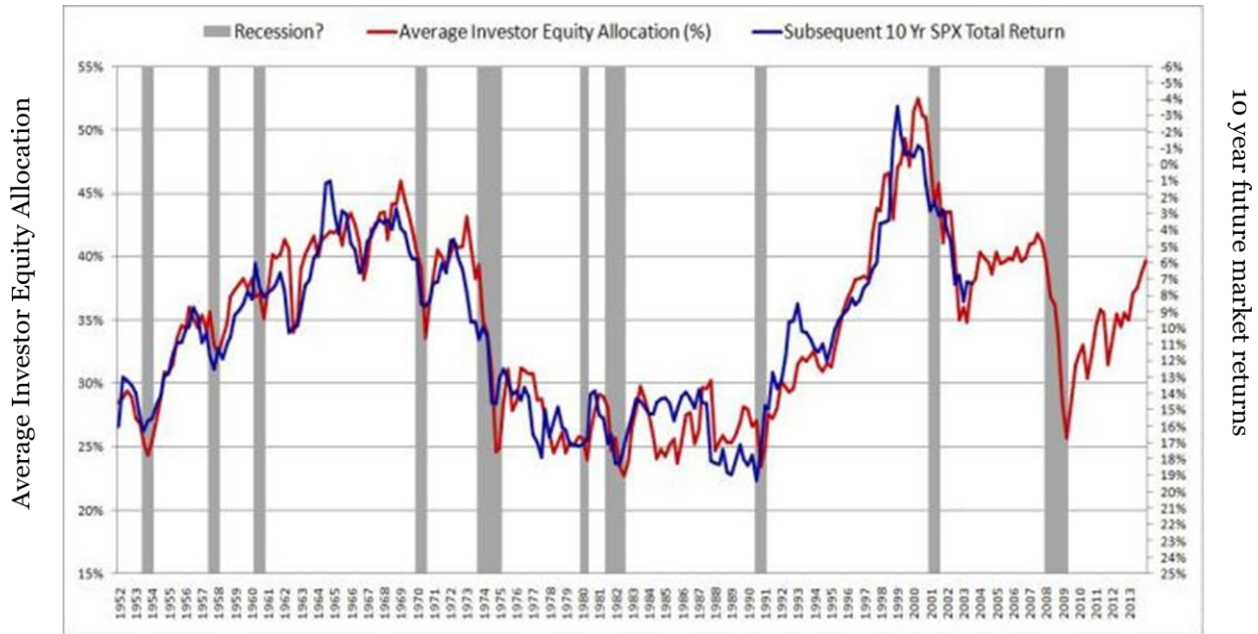
Valuation	S&P 500 Average Percentage Gain Years Later (S&P 500% Over/Under Valued March 1926 to May 2014)				
	6 months	1 year	2 years	3 years	5 years
Above 20%	-0.20	-3.60	-1.60	6.80	-0.30
Below 20%	14.00	19.40	30.10	47.30	65.30
Market	3.90	8.00	16.00	23.60	39.70

Source: Ned Davis Research

As can be seen the difference in performance is dramatic. On average, one year after a low valuation, the market rose by 19.4%. One year after a high valuation, it dropped by 3.6%. When the market has been fairly valued, it increased 8.0%. The longer-term numbers are even more dramatic with an undervalued US market returning 65.3% over five years versus -0.3% for an overvalued or expensive market.

Ned Davis Research estimates the median P/E ratio of the S&P 500 index over the long term at 16.7. At a current P/E ratio of circa 20, a fair valuation for the S&P 500 is around 1550. The S&P 500 is currently at around 1940, suggesting the market is more than 20% overvalued.

Another way of showing this relationship is to consider the following chart which shows the average investor portfolio allocation to US equities from January 1952 to December 2013:



Source: Philosophical Economics

What this chart in essence shows is that when the average investor has a high allocation to equities (left hand axis) returns over the following 10 year period are low to negative (right hand axis).

What this implies is that it is risky to buy US equities right now. Yet it is important to note that the market could continue its upward movement even further - driven by QE (and low interest rates), foreign capital inflows or the return of the retail investor. Whilst not seeking to predict future US equity returns we are simply pointing out prospects for future gains in the US 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.

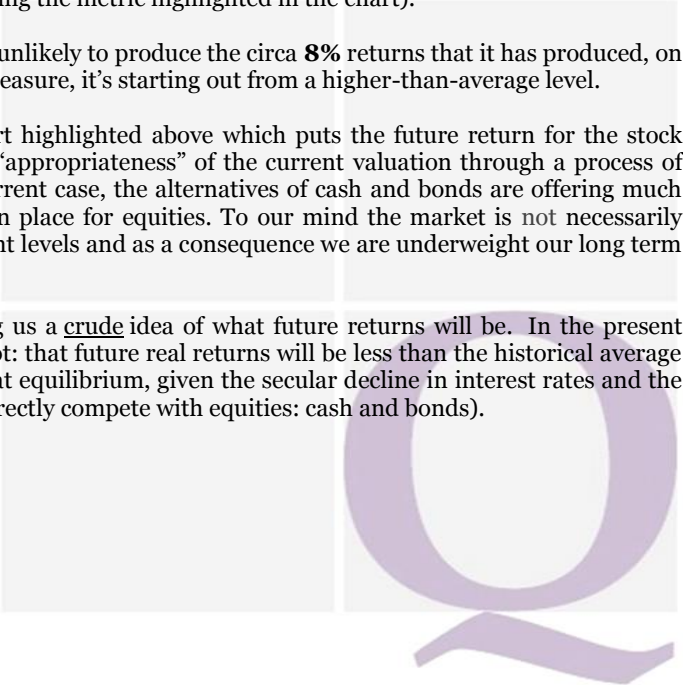
There's a debate right now between bulls and bears over whether the U.S. stock market is presently overvalued. What, precisely, does it mean to say that something is "overvalued"?

When we say that the stock market is "overvalued", we might mean that it's currently valued more expensively than it typically has 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 it's priced for **5%** or **6%** (using the metric highlighted in the chart).

There are many reasons why the present stock market is unlikely to produce the circa **8%** returns that it has produced, on average, throughout history. On almost every relevant measure, it's starting out from a higher-than-average level.

If you estimate long-term equity returns using the chart highlighted above which puts the future return for the stock market at 5% to 6%, then it makes sense to assess the "appropriateness" of the current valuation through a process of comparison with the investment alternatives. In the current case, the alternatives of cash and bonds are offering much less than 5% to 6%, so there's a decent risk premium in place for equities. To our mind the market is not necessarily "overvalued" it just does not look that attractive at current levels and as a consequence we are underweight our long term strategic asset allocation.

In the end, valuation metrics are only capable of giving us a crude idea of what future returns will be. In the present context, they can tell us what we already know and accept: that future real returns will be less than the historical average (a perfectly appropriate outcome that we should expect at equilibrium, given the secular decline in interest rates and the below-average implied returns on the assets that most directly compete with equities: cash and bonds).



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 adjusted on a shorter-term tactical basis depending upon our economic and investment views.

There have been minor changes across risk profiles in the 1st half of 2014. In our risk profiles we have:

- Marginally increased our equity exposure. The odd one out here appears to be our Cautious mandates where it looks like we have cut exposure. This reflects a timing issue where we were adding exposure over the reporting period.

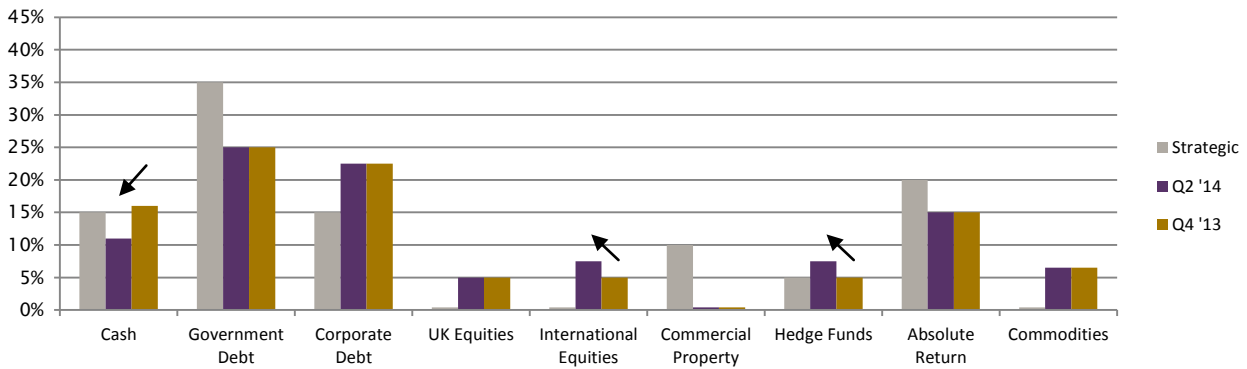
We found a good entry point in February to initiate a position in emerging market equities. While we have wanted to increase our equity exposure we were only prepared to do this where we could see good value, and emerging markets look to be cheaper than developed markets on most measures.

- Selectively increased hedge fund exposure primarily in debt markets for our more cautious mandates.

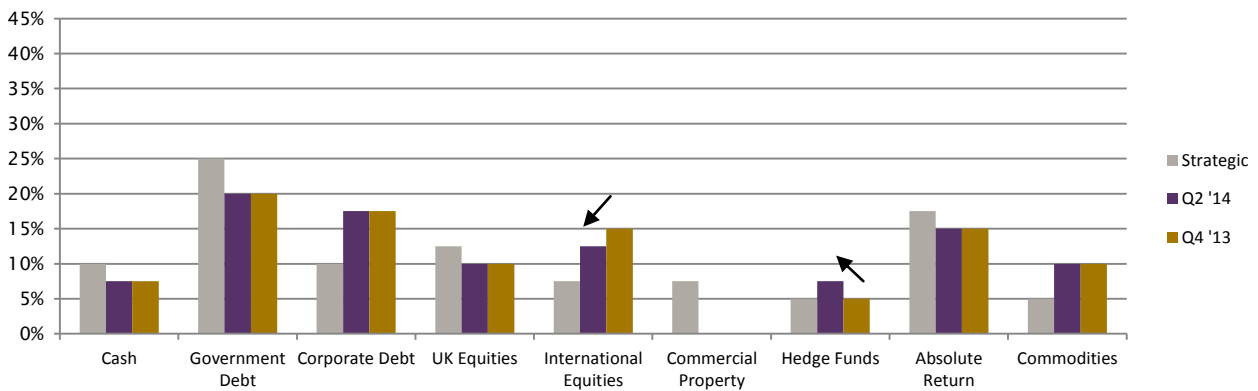
The following four charts show how our tactical asset allocations have changed quarter-on-quarter and also the positioning relative to the longer term strategic asset allocations.



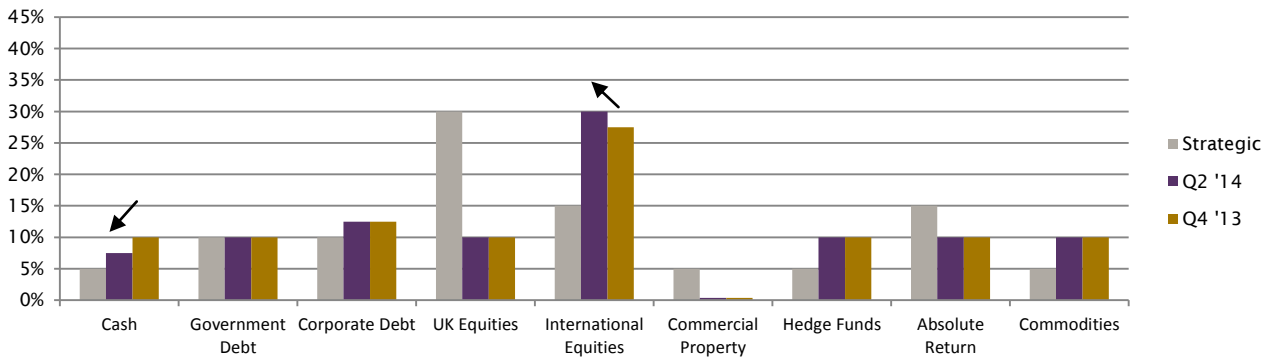
Capital Preservation asset allocation



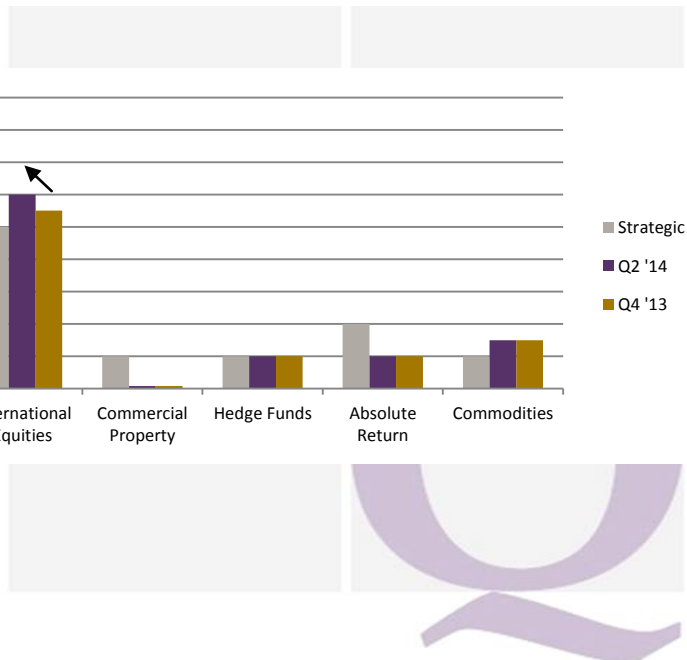
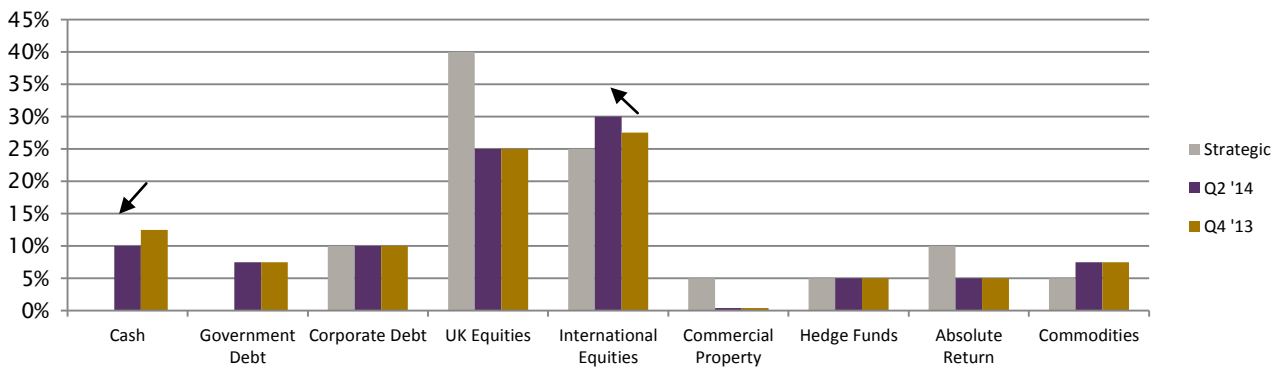
Cautious asset allocations



Balanced asset allocations



Aggressive asset allocations



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

Cash

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.

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 over the coming years.

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 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. As noted earlier we increased our exposure to international equities over the period.

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 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 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) via email or on (020) 8939 2920.

Quartet Investment Managers

July 2014

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