

## Client Newsletter October 2012

Welcome to the autumn edition of the 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

After the drama of the first six months that ultimately saw the UK market move sideways, the third quarter has seen the market move a little higher.

#### FTSE 100 Index (1 July – 30 September)



Source: [londonstockexchange.co.uk](http://londonstockexchange.co.uk)

Whilst the London Olympics captured the world's imagination and briefly diverted attention away from global troubles for a couple of months, they were brought sharply back into focus again as we entered September.

The most worrying news came from China, where data released suggested a more significant slowdown is underway than most commentators have been predicting.

Slightly more positive news came from Europe and the US. The European Central Bank finally announced some meaningful measures to help the Eurozone crisis, with the announcement by Mr Draghi that he will do "whatever it takes" to save the Euro, and the US launched another round of quantitative easing (QE3). However, the big questions that remain are how effective these latest measures will be, and how bad is the underlying situation for these measures to be announced in the first place?

### 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.

We will look to discuss these themes in our letters over time but have chosen to focus specifically on three of these due to recent developments.

#### ■ **Eurozone sovereign debt crisis**

The recent "whatever it takes" comment from the Head of the European Central Bank (ECB) Mario Draghi could be a turning point for the European financial crisis, but we have been here before - strong words followed by little action. The glimmer of hope this time is that the mechanism now in place to try and save the Euro is potentially a step in the right direction. It also helps that Mr Draghi is the first person in charge of the ECB (in recent history)



to truly appreciate that markets have the power to make or break a country in the current environment and as he said, he will watch and act as required.

For such a bold statement to be made however, we as investors should be wary of just how severe the underlying situation is:

- The Greeks continue to “negotiate” over the austerity terms imposed on them.
- Spanish unemployment is reaching all time highs, capital continues to flow out of the country and Spain as a whole edges ever closer to a full blown bailout.
- Italy appears to be heading the same way as Spain, although maybe 12 months behind.
- France could well be the next nation in trouble following the lowering of the pension age, the punitive tax on ultra-high earners, their banking exposure to the European peripheries, and the recent protectionist activity. France of course denies there are problems, but then so did everyone else (see statements below!)

*“Spain is not Greece.”*

Elena Salgado, Spanish finance minister, February 2010

*“Portugal is not Greece.”*

*The Economist*, April 2010

*“Greece is not Ireland.”*

George Papaconstantinou, Greek finance minister, November 2010

*“Spain is neither Ireland nor Portugal.”*

Elena Salgado, Spanish finance minister, November 2010

*“Ireland is not in ‘Greek territory’.”*

Brian Lenihan, Irish finance minister, November 2010

*“Neither Spain nor Portugal is Ireland.”*

Angel Gurría, Secretary-general of the OECD, November 2010

*“Italy is not Spain.”*

Ed Parker, Fitch MD, June 2012

*“Spain is not Uganda.”*

Spanish PM Mariano Rajoy, June 2012

*“Uganda does not want to be Spain.”*

Ugandan foreign minister, June 2012

*Source: Artemis Fund Managers Ltd*

As we highlighted in our last newsletter Germany looks increasingly like Europe’s odd one out, as the rest of Europe’s southern countries see their dire situations become more aligned. As the well-regarded economist David McWilliams recently wrote, “Be under no illusion: the euro can only survive if it looks more like the lira than the deutsche mark” and that appears to be the direction in which Europe is slowly heading.

Overall Europe has a long, long way to go before the current crisis is resolved, but it is just possible that the politicians in charge are beginning to take it more seriously now. As the old adage goes, ‘Actions speak louder than words’ and we now need to see the action!

What about investing in Europe? We have been keen advocates for over a year now and have recently added further exposure to European equities for many clients. Whilst we obviously feel there are huge problems, investment opportunities do still exist. Europe has some top quality companies that continue to perform well and generate the majority of their revenue from other parts of the globe, yet these companies saw their share prices suffer as investors panicked.

As we have mentioned in previous newsletters, long-term investment is all about paying the right entry price. Whilst no one can profess to get this right all the time, we felt European share valuations in general had reached a very cheap level in September/October last year and decided to buy, going against the flow of most other investors. We still feel excellent value exists, but the ride over the next few years may be bumpy.

### ■ **Fears over weaker US growth**

Over the first half of 2012 the US seemed to be the only ray of sunshine in an otherwise gloomy global economy. Whilst economic growth was tepid, at best, at least it was growing, and this provided encouraging signs for the future as far as investors were concerned, pushing the leading US stock markets to multi year highs. However, the picture is changing.

Back in the summer the Fed (the US equivalent to the Bank of England) had refused to give in to market pressure and start printing money. As far as Ben Bernake was concerned the US economy was on a sound footing and recovering. However, something changed in September and instead of just announcing a set amount of

quantitative easing (QE), the Fed announced an indefinite amount. Commentators have called this latest round QE3 (as it is the third cycle), but why not call it QE infinity?

Unlike most investors we have been very wary of the US this year, as the economy is heading for some major obstacles, and the Fed confirmed our fears through its latest actions. To make matters worse, the US presidential election outcome remains on a knife-edge, and a Romney win (an outcome we never thought would be likely a few months back) could potentially make matters worse for the US economy. Ignoring the election however, it is the “Fiscal Cliff” and “Debt Ceiling” that have been on our radar this year.

The Fiscal Cliff is a set of tax rises and spending cuts that will take place at the very start of 2013. It will see various unemployment benefits removed, payroll tax cuts expire and other tax cuts introduced by George W Bush revoked. In total these policies added around 2-3% to the US GDP figure. Given the official GDP growth figure is less than 2%, this one event on 1 January 2013 will send the US straight back into recession.

Added to the fiscal cliff is the political wrangling over the upcoming debt ceiling. This is the amount of debt that the US is allowed to have outstanding and is regulated by the government. Whilst it will undoubtedly be raised again (meaning the US government can create more debt), leaving approval to the last second as happened two years ago will worry markets.

Both a recession and the creation of more debt will be unpopular in the US, especially when the job market remains despondent. From our point of view, the major worry over the coming 5 years is the mountain of debt the US is creating. All other indebted countries are trying to reduce debt, whilst the US forges ahead with creating more. At some point this must be addressed, but then maybe this explains QE infinity (and the long term aim of creating inflation) being deployed - an attempt to inflate away the debt.

Finally onto valuation: the US equity market (S&P 500) currently trades at a Shiller price to earnings ratio of around 21.5. This is 30% higher than its long term average. Whilst markets can remain overvalued for long periods a 30% overvaluation indicates to us lacklustre returns going forward and possibly quite big downside risk.

Overall, we remain wary of investing further into the US and await the outcome of the US election.

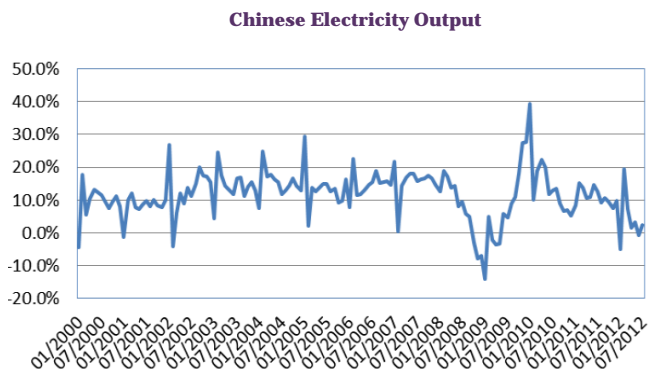
### ■ *Slowdown in China*

The big question for economists at the moment is whether China is likely to experience a hard or soft economic landing – i.e. can they control the economic slowdown they are undoubtedly experiencing? Whilst the majority feel that China has the situation under control, there is a small group of economists who feel their beast of an economy is gaining the upper hand.

Looking at the official data released by the Chinese the picture shown is one of a controlled and expected slowdown that remains on target. However, the fact they release their quarterly GDP numbers only a few weeks after the end of each quarter should raise serious doubt about the validity of these “official” figures given the size of China’s economy.

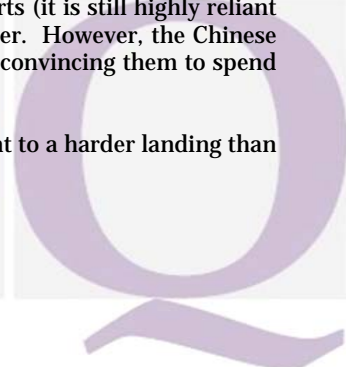
It is only by taking a look at other factors such as electricity output (see graph) and freight traffic that the true picture begins to emerge, and it is one of a country slowing faster than official figures suggest.

In reality a country cannot keep growing at the pace China has over the last 15-20 years, and a slowdown has been expected for a while. However, whilst the economy will not enter an official recession, too fast a slowdown in the short term will feel like a recession to the population at large.



At the same time we see an economy that desperately needs to shift its emphasis away from government infrastructure spending (how many more roads and airports can they build?) and exports (it is still highly reliant on the European and US consumer), towards one that is led by their domestic consumer. However, the Chinese population has one of the highest global savings rates (40% of disposable income) and convincing them to spend some of their money and/or savings during a “recession” will not be easy.

On top of all of this is a change of leadership this year. In our view all these factors point to a harder landing than many are predicting, but do not expect official figures to reflect reality!



Overall, our view on China's economy is that the short-term does not look rosy. On the other hand the interesting part to the Chinese story is that in spite of the troubling economic outlook, the stockmarket is beginning to look good value on a long-term basis as it nears 5 year lows. The stockmarket has performed in an almost exact opposite fashion to the economy, and clearly demonstrates that strong economic growth does not mean positive stockmarket returns. Whilst we are likely to hold off investing for a little while longer to see how the economic situation develops, we feel the time is nearing to start dipping our toes into the Chinese market.

### What does this mean for Quartet's client portfolios?

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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.

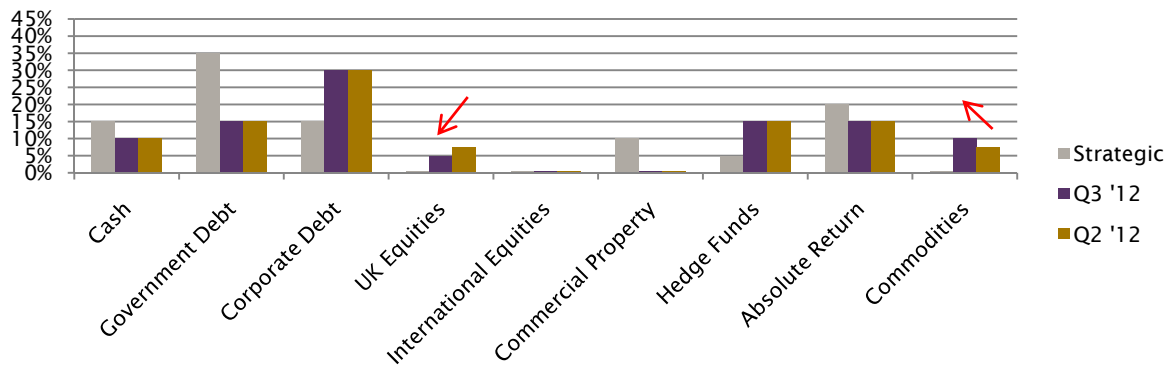
There was little change across asset allocations over the quarter. The main actions taken are as follows:

- **Capital Preservation:** We marginally reduced our UK equity exposure whilst introducing a position in Agriculture related equities. Our net exposure to "equities" therefore remained unchanged.
- **Cautious:** As with our Capital Preservation mandate we added a position in Agriculture related equities at the expense of some UK equity exposure. We also marginally increased our international equity exposure using up some of the cash.
- **Balanced:** We added a position in Agriculture related equities using up some of the available cash.
- **Aggressive:** Like other mandates we added a position in Agriculture related equities using up some of the cash and also modestly reducing our UK equity exposure.

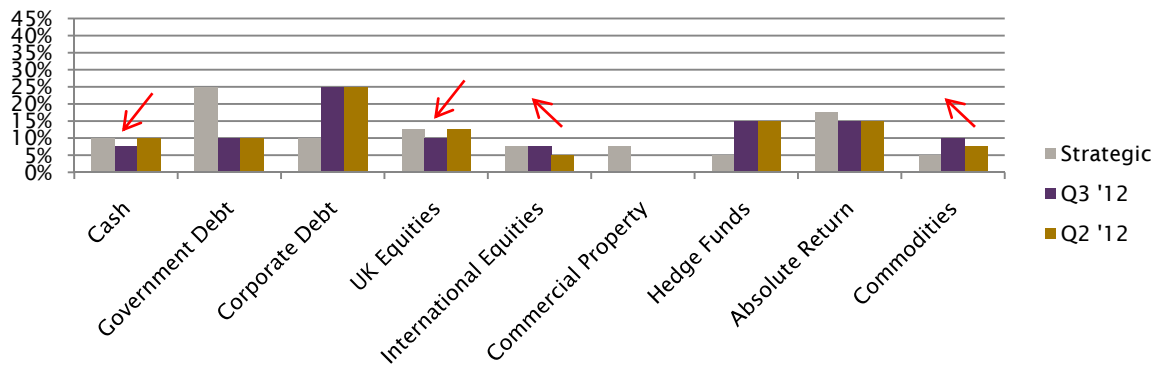
Detailed below are four charts showing how our tactical asset allocations have changed quarter-on-quarter and also the positioning relative to the strategic asset allocations.



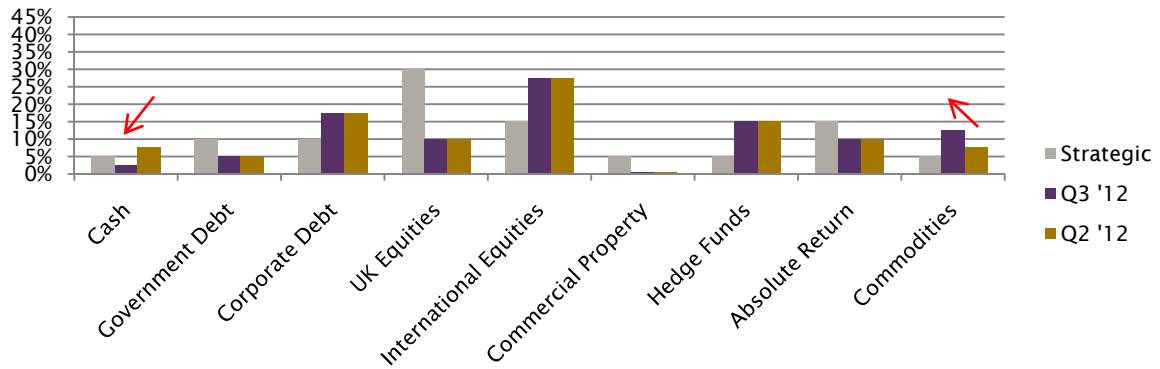
### Capital Preservation asset allocations



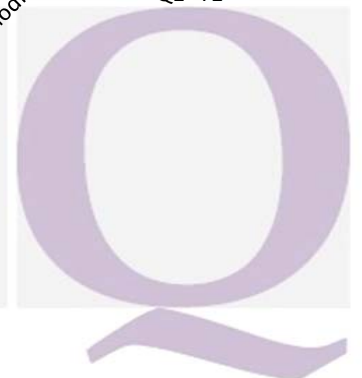
### Cautious asset allocations



### 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 provides next to no return as an investment. Cash does, however, allow us to take advantage of investment opportunities as and when they arise. Over the quarter we reduced cash in most mandates.

### Government Debt

We are significantly underweight government debt across all portfolios. Whilst we have benefitted from the safe haven status of UK government gilts by holding them over the last few years, the interest yields received are at all-time lows and generating negative real returns. As a consequence we see little value in this asset class at current levels and a fair amount of potential downside.

### Corporate Debt

In contrast to our government debt exposure we are overweight corporate debt for all clients. Performance has been strong year to date and we expect more upside. We expect yield to be a much bigger component of the return going forward for clients and being able to earn an income yield of 5-6% with reduced capital risk is attractive in this environment.

### UK & International Equities

Whilst at a headline level it appears that we have marginally cut our equity exposure we used the proceeds to purchase Agricultural related equities. We have classified these under our commodity exposure. We remain frustrated bull investors. We continue to see good value in equity markets if you are willing to buy and hold them for the next 10 years or more! However, we are also aware of the many lingering problems in the global economy that mean there could be even better opportunities to invest in the near-term. As a consequence we intend to be patient and seek opportunities as they present themselves over the coming months.

In general we are in line with our strategic asset allocation to equities as a whole. The only exception is for our Capital Preservation clients, which remains marginally overweight UK Equity exposure, as a result of our longer term desire to have a modicum of equity exposure in the portfolios.

### Commercial Property

We are very underweight relative to our Strategic Asset Allocation weightings, having no exposure at all. Commercial property prices are, over the longer term, correlated to GDP growth. As we expect minimal growth over the next few years we have no property exposure.

### 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 (to date we have been wrong!). 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.

### Commodities

We are overweight Gold as an asset class, which we use as an insurance policy should a significant macro-shock hit the global economy. 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 (see our comments earlier in this letter).

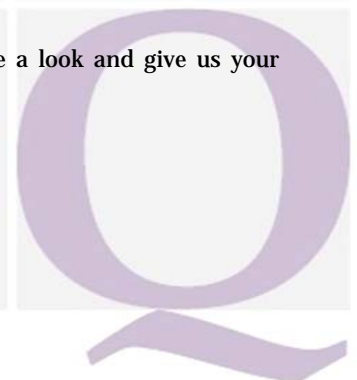
We are very positive towards Agriculture over the long-term (please see our Summer newsletter) and have introduced exposure across all risk mandates.

## News

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We are very pleased to welcome Sebastian Ladimeji to the team who has joined as Intermediary Sales Director and also Clayton Harris to assist with client administration.

We will be launching our new website over the next couple of weeks, so please take a look and give us your thoughts: [www.quartet-im.com](http://www.quartet-im.com)



## 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**.

We believe that 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 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 who have all attained chartered status, have worked together for a number of years, 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 either Colin McInnes ([cgm@quartet-im.com](mailto:cgm@quartet-im.com)) or Nigel Olliff ([njo@quartet-im.com](mailto:njo@quartet-im.com)) via email or on (020) 8939 2920.

## Quartet Investment Managers

November 2012

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