Client Newsletter April 2017

Welcome to the first Quartet Newsletter of 2017. 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 markets

Since the start of the year global markets have enjoyed a positive, albeit somewhat volatile, return amid an upswing in global economic data. Equity markets rose on anticipation that President Trumps reflationary policies would continue to stimulate the US economy. Recently there has been a pullback following his failure to repeal Obamacare.

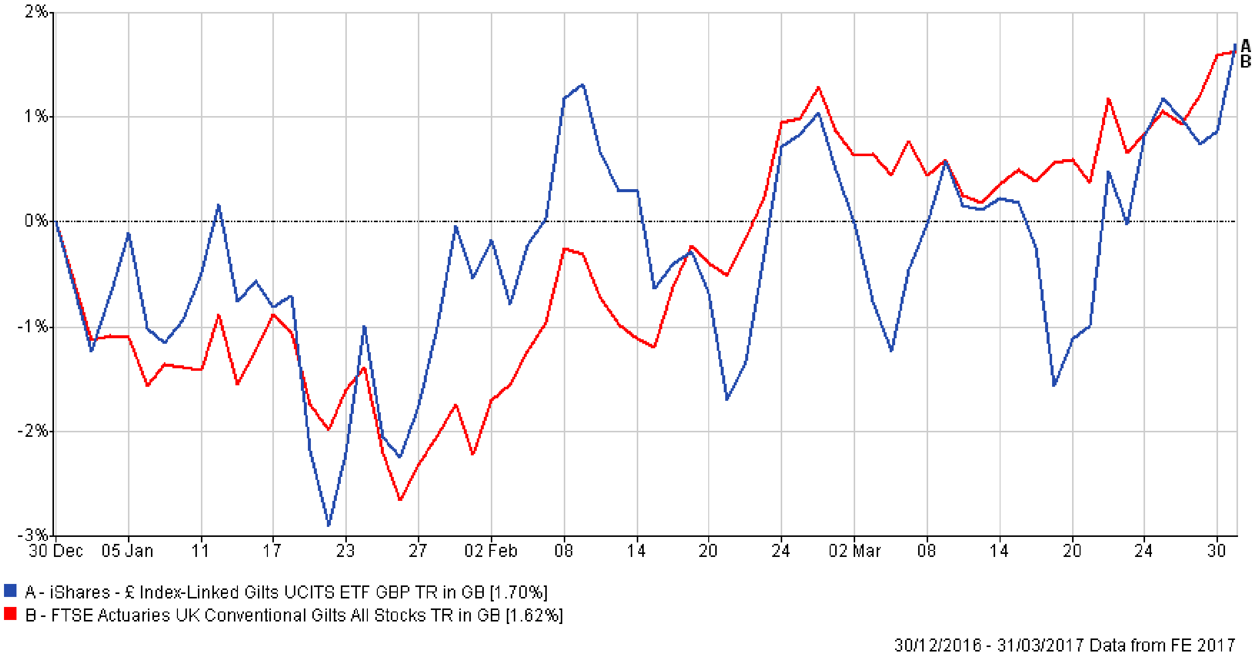
US equities advanced to fresh all-time highs, supported by positive economic data and President Trump's plans to cut taxes and regulations. Eurozone equities delivered robust gains amid upbeat economic releases and receding political worries following the win for the centre-right in the Dutch elections. UK equities gained, supported by solid corporate results and merger & acquisition activity. Article 50 was triggered at the end of the period, signalling the formal start of the process to leave the EU. Japanese stocks saw positive but muted returns with the yen gradually appreciating over the quarter. Emerging markets registered a robust return. An upturn in global growth and a lack of follow-through on protectionist trade policy from the Trump administration supported risk appetite.

FTSE 100 Index (31 December 2016 – 31 March 2017)

Source: Portfolio Sharing

The Bond Market (31 December 2016 – 31 March 2017)

The chart below shows the UK Gilts (red) and UK Index Linked (blue) government bond indices.



Source: FE Analytics

Optimism over the strengthening global economy and potential pro-growth effects from President Trump's fiscal stimulus plans continued to drive markets in the quarter. Data showed real economic activity continuing to pick up with yet further evidence of synchronised global reflation underway. The shift toward monetary policy normalisation also continued. The Federal Reserve in the US raised rates and the ECB signalled it sees less need for accommodative policy going forward. Detail over Trump's fiscal plans remained generally thin, but significant doubts about his ability to implement reform were planted in March after a failure to repeal Obamacare. Politics in Europe remained a worry for markets as nationalist politicians continued to command support, although concerns receded somewhat towards the end of the period.

Against the backdrop of strengthening growth, rising inflation and marginally more hawkish central banks, global corporate bonds outperformed government bonds albeit both produced positive returns.

Views on current equity market valuations

Following the recent IPO of Snapchat (ticker: SNAP) in early March where the company raised $3.4 billion and valued the overall business at nearly $24 billion we thought it an opportune time to review overall equity market valuations. Much of the comment will focus on the US market but applies equally to other major developed markets.

The IPO was nearly 12 times oversubscribed and this for a business that lost $515 million on revenue of $404 million in 2016 compared with a loss of $382 million on revenue of $59 million in 2015. Interesting given the demand for shares is that shareholders have no voting rights! One might be thinking that this echoes a similar time in 2000 just before the last major equity market fall.

Detailed below is a chart showing the performance of the S&P 500 from January 2009 till the end of March 2017

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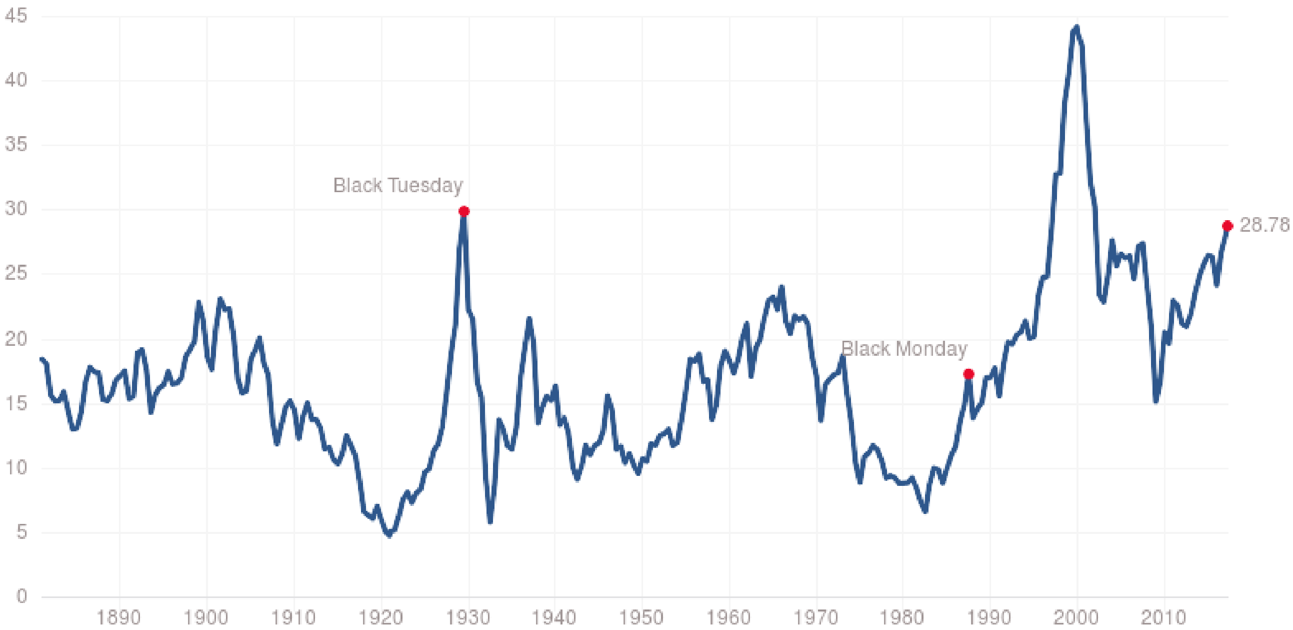
Source: www.multpl.com/shiller-pe/

As can be seen, baring a few hiccups, it has been a pretty strong upward march. At the same time the price to book value of the S&P 500 has risen from just over 1.75 to now just over 3 (you are paying 3 times the book value of the assets). The long-term average is around 2.7 times. Whilst this does not seem to imply any significant overvaluation the more interesting statistic is what has happened to earnings.

A cyclically adjusted price/earnings ratio, otherwise known as the Shiller PE, measures the price of a company's stock (or overall market) relative to average earnings over the past 10 years adjusted for the impact of inflation. The smoothing achieved by looking at earnings over a 10-year period avoids concluding a stock or market is cheap or expensive based on unsustainable one-year swings in profits, either up or down.



Source: www.multpl.com/shiller-pe/

As can be seen the current Shiller PE Ratio for the S&P 500 is 28.78 (the long-term average is 16.74). Whilst the price to book ratio implies the S&P 500 is marginally overvalued, the Schiller PE Ratio shows a much worse position and a significant overvaluation of the equity market.

Whilst we do not think we are due a sudden fall in the S&P 500 the current valuation level impacts our expectations of future returns. Whilst valuations do not matter in the short term, overvaluation can last for years, longer term they do. At current valuations, the US S&P 500 equity market has historically delivered a negative real return over subsequent periods of 2 to 5 years. The average real return over the subsequent 5 years, going back to 1928, is -15%.

Even if we are wrong and President Trumps reflation of the US economy keeps on going one should appreciate that market have huge expectations already priced in and any disappointment will more than likely result in negative returns for equity investors over the medium term.

Outlook

Our views for the remainder of 2017 remain broadly unchanged:

1. Whilst we had been expecting slow but positive economic growth with limited recession risk we think the impact of BREXIT on the UK could now push us into a mild recession.

2. Whilst the US Federal Reserve has started to raised rates we think the market is potentially underpricing further rises. US growth remains reasonably robust and inflation has ticked up. We think the Fed may be behind the curve and may have to raise rates three rises during the rest of 2017. This would obviously be bad for US Treasury bonds.

3. Currencies remain a powerful force in markets and the path of the US dollar is, as ever, being closely watched. With the risk that the US Fed may raise rates more than expected we think the US Dollar will remain strong against other major currencies.

4. Equity markets continue to surprise us on the upside and should the Trump reflation package disappoint we think US equities will struggle. On the other hand, we think there is decent upside potential in Japan and Europe where valuations are much less demanding. We expect volatility to rise from the current low levels due to increases in geopolitical risk.

What alterations have we made to Quartet's client portfolios since 30 September 2016?

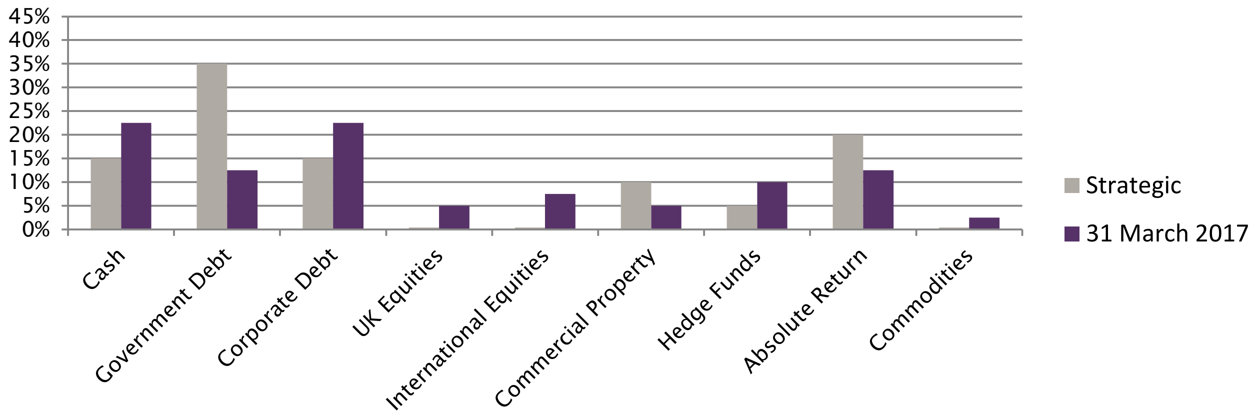
Our prime focus is on the management of client portfolio asset allocations, and as you will be aware the initial building block that we start with in the construction of each client portfolio is one of four strategic asset allocations as defined by the following risk profiles – Capital Preservation, 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 all risk profiles since 31 September 2016:

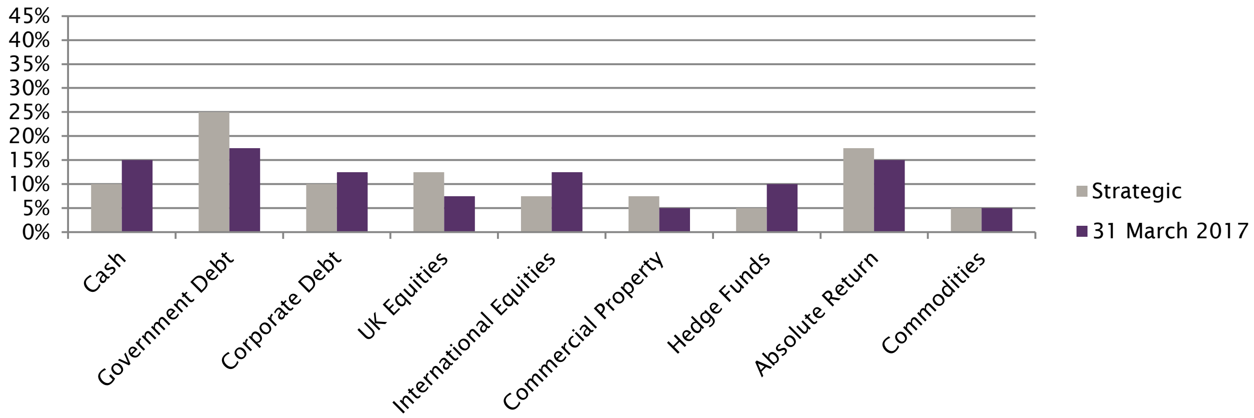
- We have reduced our UK Index Linked Gilt exposure across risk mandates following the strong performance in the asset class in 2016.
- We reduced our European equity exposure in early Q4 as geopolitical risk rose in France and the Netherlands.
- We introduced a position in an infrastructure vehicle for all risk mandates in Q1 of this year via a share placing. Our allocation got significantly scaled back so we took profits of circa 4% within days of the investment.
- We tendered shares back to the company in one of our alternative investments and expect proceeds in May 2017 providing a 5% uplift in the valuation.

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

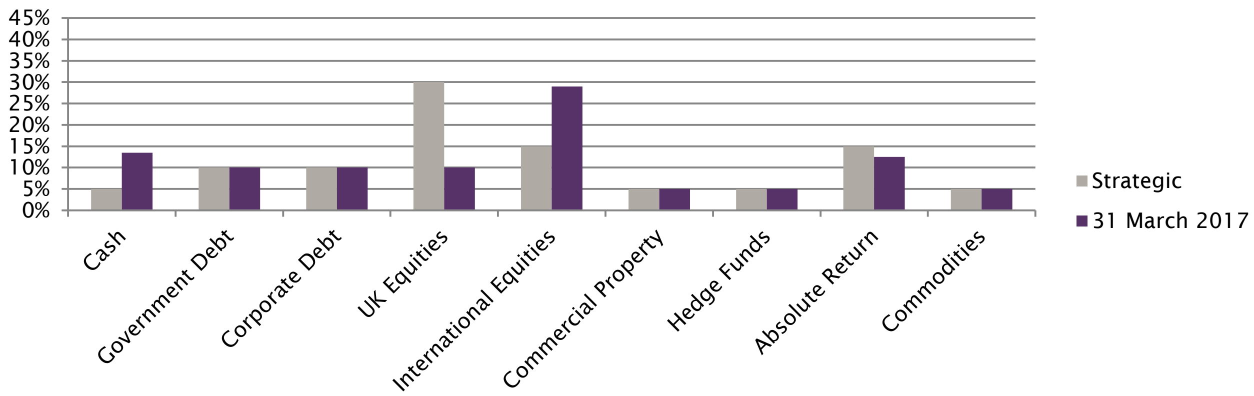
Capital Preservation asset allocation



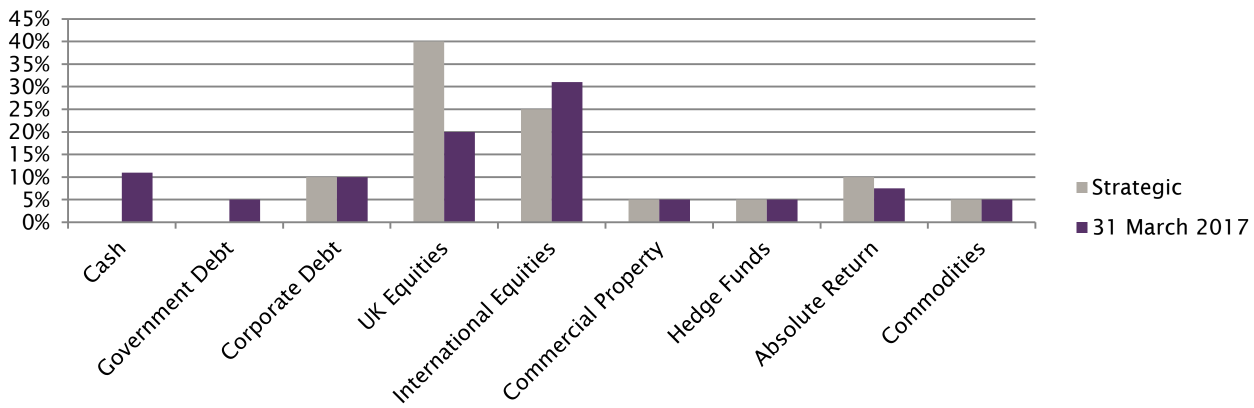
Cautious asset allocation



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 very overweight Cash across all portfolios. We recently sold over half of our Index Linked Gilt exposure and have yet to reinvest the proceeds.

Government Debt
We are significantly underweight conventional government debt across all portfolios and have recently reduced our position in UK index-linked securities. We remain positive towards the US equivalent, TIPS, and retain exposure across all risk mandates.

Corporate Debt
We are now neutral to marginally overweight conventional corporate debt exposure for all risk mandates. Whilst we expect some upwards movement in UK interest rates we think these are still some way off and will be implemented very gradually.

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

Commercial Property
We have exposure to Commercial Property across portfolios. Our sole investment holding leases Primary Healthcare Centres to the NHS so is in part an infrastructure investment. Capital growth has historically been in line with inflation but the yield is close to 7% per annum which we like in the current low interest rate environment.

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.

We currently have included our Infrastructure position within this category but may split this out in the future.

Commodities
We now have minimal exposure to 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.

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

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