UK Euro referendum commentary

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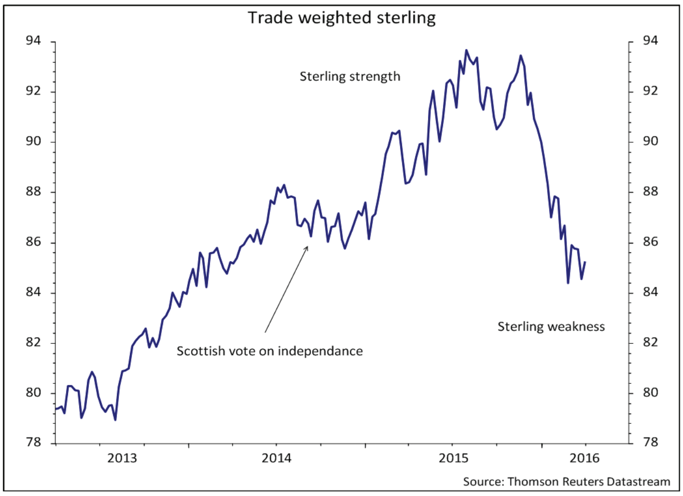
Gill Lakin
Chief investment officer

Brexit: UK equities – the "heads you win, tails you win" asset class

After the intense media coverage of the "Brexit" debate and with more than two months still to go until the 23 June referendum, investors may already be suffering from "Brexit-fatigue". I have no wish to add to the vast column inches devoted to the pluses and minuses of European Union (EU) membership. My aim as a fund manager is to ensure clients are positioned to weather the potential storms that lie ahead, not to form an opinion on the result, and not to structure their portfolios in a "heads you win, tails you lose" way. Fund managers should only invest when they believe they have genuine insight and conviction that their decisions will generate real returns for clients. So how have I positioned clients' portfolios in advance of a binary outcome such as the "stay" or "leave" referendum decision?

The performance of markets in response to the Scottish independence vote in September 2014 is a useful case study. Sterling weakened some weeks before the vote and fell even further after a rogue opinion poll put the "yes" campaign in the lead. It is a truism that "markets dislike uncertainty" and investors duly responded to the risks of a divided UK by selling sterling, as shown in the chart below. Sterling has weakened again recently as investors have attempted to "price" the risk of the UK deciding to leave the EU.



Sterling has, of course, been weakened recently by other factors such as the decreasing probability any time soon of the first UK interest rate rise since the credit crisis but the uncertainty surrounding the Brexit vote must also account for some of the recent slide.

Sterling assets justifiably constitute a significant proportion of many clients' portfolios because their future spending is likely to be denominated in sterling. A significant currency mismatch between assets and liabilities could leave clients with a shortfall if currencies moved the wrong way. I have generally concentrated clients' sterling investments in UK equities because this asset class should ultimately benefit from a falling pound as this will increase the competitiveness of UK companies in export markets.

If voters decide Britain should stay in the EU, UK equities are likely to perform well because the currency and the stockmarket should rise on the news of a decision to stay.

A "leave" vote would, however, most likely hurt our currency and our stockmarket in the short term. The improvement of our terms of trade would, however, ultimately prove a silver lining that makes equities the most attractive sterling assets to own at this time. UK equities should do well in the longer term whether we stay or leave and this potential asymmetry in returns – "heads you win, tails you win" – should attract investors and deliver good longer-term returns from this asset class.

In recent months, I have selected UK equity funds with holdings in larger companies because these businesses are likely to be more global, with a higher proportion of non-UK revenue.

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Blue chips may also be better equipped than some smaller peers to cope with the potential challenges a big revision of trading terms with the EU would bring.

The benefit of a multi-asset portfolio is, of course, that many investments will remain largely unaffected in local currency by the outcome of the Brexit vote. I believe emerging market equities currently offer a good investment opportunity. Emerging markets have underperformed developed markets in recent years and are now relatively lowly valued, as the chart below shows.

Emerging market equities have lagged developed economy peers as the headwinds of a stronger dollar and weak commodity prices have resulted in capital flight. I have become less positive on the outlook for the dollar as the prospect of a rapid succession of US interest rates fades, with the Federal Reserve becoming increasingly dovish. The chair, Janet Yellen, said recently the Fed would proceed cautiously when increasing interest rates. Commodity prices have also moved above recent lows as falling US oil output and signs of financial distress amongst US shale producers increase the likelihood of some oil price recovery. Over the first quarter of 2016, there was a significant reversal in the prevailing trends of the preceding few years as emerging market equities outperformed global equities in sterling terms.

Currency markets are notoriously unpredictable but many emerging market currencies are trading close to multi-year lows against the pound so there may be another reason why investments in these markets could provide strong returns for a sterling investor, particularly while Brexit fears continue to depress the pound.

Important information

Brompton Asset Management LLP, 1 Knightsbridge Green, London, SW1X 7QA