BROMPTON
ASSET MANAGEMENT

UK referendum result commentary

5 July 2016

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Brexit Britain: positioning Brompton's investment strategies

It has a been a bruising few days for the British psyche as 51.9% of those who voted in the European Union (EU) in-out referendum chose Brexit, leaving 48.1% facing an outcome they had not endorsed. Importantly, a majority of voters in Scotland and Northern Ireland voted to remain, potentially threatening the future of the United Kingdom. The high turnout on polling day is testament to the strength of opinion across the country as practical considerations of the pros and cons of EU membership were swept up with issues of globalisation and national identity. The referendum result highlights the division of opinion across the UK made manifest in the relatively small margin of victory for "leavers". People found common ground, however, in the view that the "leave" and "remain" campaigns were remarkable for their focus on the negative consequences of either outcome.

June 24 turned out to be one of those days you know you will recall where you were when you heard the news. I drove past Downing Street before the results had finished coming in and saw the crowd of reporters who later witnessed the prime minister's resignation speech. The significance of these events largely eluded my 11-year-old son although his future will be influenced by them but even he registered it had been a difficult week for England when we lost to Iceland in the European Championship and Roy Hodgson joined David Cameron in reconsidering his career plans. I am, however, told there can be only one opinion on this subject.

How did Brompton's investment strategies perform?

All Brompton's investment strategies delivered positive sterling returns in June despite Brexit. The referendum result confounded pollsters, bookmakers and markets. Brompton's multi-asset strategies were invested across asset classes to harness the benefits of diversification and protect clients' wealth whatever the outcome. It is dangerous for a fund manager to take a view on a political event of this kind, then position portfolios to benefit disproportionately from one outcome. I did, however, focus on identifying investments such as UK larger companies that could do well in the medium term whatever the outcome.

Many investors will have seen the lurid headlines announcing the falls in sterling and share prices following the result. One front-page article proclaimed that "markets" had fallen to 30-year lows. Yes, some assets fell sharply on the day but not all and others rose. So, how have asset classes responded to Brexit?

Global equities rose in sterling terms

Global equities gained 8.28% in sterling in June as the dollar, yen and euro gained 8.88%, 17.70% and 8.66% respectively against the pound. Asia ex-Japan and emerging economy equity markets outperformed, rising 11.90% and 13.34% respectively in sterling. I added emerging market equity holdings in some strategies and increased such holdings in others earlier in 2016 because I saw signs that the twin headwinds of a stronger dollar and falling commodity prices were abating. Thus, all Brompton's investment strategies benefited from significant allocations to these markets.

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UK equities gained

Although UK stocks fell on the day of the result, sterling's fall proved a silver lining. The weaker pound has improved the export competitiveness of UK businesses, boosted the translated value of overseas earnings and may arguably more than compensate for any resultant trade tariffs. After the initial adverse reaction, UK shares recovered to post a 4.97% gain for June.

UK large companies outperformed smaller companies

UK larger companies significantly outperformed smaller companies, which fell during June as investors responded to the uncertain prospects for the domestic economy. Brompton's preference for funds focused on large companies proved beneficial. These businesses will benefit more than domestically-orientated smaller companies from sterling's fall because they typically have a higher proportion of export sales and/or overseas earnings. They are also arguably better equipped to deal with the challenges of renegotiating trade terms.

Banks and property stocks fell

UK banks and property companies fell sharply following the result. The receding prospect of UK interest rate rises may lead to slower earnings growth for banks. Property stocks underperformed because investors fear that overseas investors are less likely to invest in the UK if it is no longer in the EU. Property shares may recover more swiftly than banks because sterling's fall means UK property will be cheaper for overseas buyers. In general, however, my preferred UK equity funds such as Lindsell Train UK Equity and Liontrust UK Special Situations had low holdings in these sectors because of their managers' investment philosophies.

Europe ex-UK underperformed in sterling terms

I was cautious about Europe ex-UK equities before the vote because I feared a "leave" decision might increase support for anti-EU political parties and reignite investor concern regarding the future of the EU and the euro. I remain cautious and do not plan to increase Brompton's allocation to the region.

Longer-dated government bonds rose

Clients' investments in funds invested in longer-dated UK government bonds and global inflation-linked government bonds performed well in early 2016 when equities fell on fears of deflation stemming from Chinese currency devaluation and falling oil prices. These investments made further gains as the prospect of interest rate rises receded. Gilt and US treasury yields fell following the referendum, with gilts delivering a 5.63% return for June.

What action has Brompton taken since the vote?

Ahead of the referendum, the investment team discussed the potential market reaction to the different outcomes. The fund managers gave thought to how major asset classes might perform and what changes might be made to the team's asset allocation in the light of the changing risks and opportunities.

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Following the Brexit announcement, clients' investments in global equities were generally increased through purchases of the sterling-hedged share class of a global equity exchange-traded fund, which should benefit from a recovery in global equities and the pound. Profits were also taken where appropriate on investments in longer-dated gilts and inflation-linked bonds.

What happens next?

In his resignation speech, Cameron said his successor would have the responsibility for invoking article 50 of the Lisbon treaty, which would formally set Brexit in motion. The subsequent negotiation of "Brexit" from the EU and new trade agreements with other trading nations may take years. This uncertainty may lead to a hiatus in capital investment in the UK. The damage to the domestic economy is difficult to quantify. Some commentators forecast a recession. At some point, UK domestic equities will become oversold and offer a good investment opportunity but the uncertainty will persist for some time so I do not currently intend to re-invest in funds focused on UK smaller and medium-sized companies. The UK's larger companies will to some extent be cushioned from a domestic slowdown by their global reach and sterling's fall may boost overseas earnings. Returns from the commodity-heavy blue chip Index are likely to be more closely linked to commodity price trends.

The monetary policies of the Bank of England and, to some extent, the Federal Reserve will be influenced by the heightened global risks resulting from Brexit and the prospect of further interest rate rises has receded. The shift in monetary conditions is positive for emerging market equities and bonds and clients' significant allocations to these asset classes have been maintained.

The heightened market volatility that accompanied the Brexit vote largely subsided in the following days but investor sentiment remains fragile. I will monitor forthcoming economic data such as US employment numbers for any indication that global growth could slow more significantly than consensus expectations. This would make it harder for markets to withstand the potential fallout from Brexit and might justify a reduction in overall portfolio risk.

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