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For Financial Adviser Use Only

Understanding the Brexit Vote

A Viewpoint from the Investment Team

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On 23 June 2016, the United Kingdom held a referendum to determine whether Britain should leave or remain in the European Union (EU). Having gained momentum in recent weeks, the "Leave" campaign ultimately proved successful, winning 52% of the vote (with more than 72% of the eligible population turning out to vote).

What happens now?

With this, financial markets saw significant volatility – U.K. equities fell; the British pound touched levels not seen since 1985 (versus the U.S. Dollar); German equities recorded early falls of 10% and despite rallying from that point, European equities in aggregate remained weak. Oil plunged 5%. German, U.K., French and Swiss bonds rallied, reflecting the flight to safety.

Whilst the vote is non-binding, there is an expectation that the government will respect the will of the British people and proceed toward formal separation from the European Union. Indeed, following the result, the British Prime Minister, David Cameron, resigned clearing the way for a pro-Brexit prime minister to be instated to lead the country toward this outcome.

What this looks like is still unclear. Prior to the vote, leaders of the "Leave" campaign said that if they were successful, they would aim to leave the EU by 2020, opting for a period of preliminary negotiations with the EU regarding trade, immigration and the free movement of people for instance, before formally notifying the Union of its intention to withdraw under Article 50 of the Lisbon Treaty,

Regardless of the exact timing, and notwithstanding the uncertainty in the meantime, the British people are in for a protracted period of negotiation. During this time, the outlook for the new landscape will become clearer, with businesses and citizens able to adjust accordingly.

What does this mean for our portfolios?

It's difficult to speculate on the longer term implications for the U.K. (and Europe) now that the campaign to "Leave" has been successful. What we can measure however, are valuations and fundamentals, as we believe that they are the key drivers of portfolio returns over the longer term. In this regard, we highlight the following points:

- **Many asset classes globally remain expensive** and so as we approach this period of uncertainty with asset prices well above their fair value, or what they are *really* worth, we would expect to see ongoing volatility. Given this, our portfolios continue to hold higher than normal levels of cash.
- **Our portfolios are well diversified** – in the event that we do go into a period of prolonged volatility, our portfolios contain investments, for example bonds, that usually perform well in times of market stress, thereby improving the overall risk profile of the portfolio. This was indeed the case in January and February's weakness, with developed-world bonds generally delivering positive returns, whilst equities fell.
- **Valuations and fundamentals remain supportive of investments in Japanese and Emerging Market equities.** In times of panic, money typically flows into safe haven assets such as the Japanese Yen. Investment flows in Japanese equities are very much driven by currency movements and so a stronger Yen often sees Japanese equities come under pressure. Similarly, flows into the U.S. Dollar in times of market stress tend to correspond to weakness in Emerging Market equities (the classic "flight to safety" trade). This is entirely consistent with what happened during the market correction that we saw in January and February 2016, albeit the catalyst was different. Now, like then, once the period of fear passes, we would expect this flow of money to reverse, giving way to the valuations and fundamentals which remain supportive for investment in Japanese and Emerging Market equities.
- **Our portfolios are not overweight U.K and European equities,** particularly regarding 'Financials' where recent weakness has been most acutely felt. Notwithstanding this, U.K. Equities are amongst the more relatively attractively priced asset classes in our investment universe. As such, whilst we may see volatility in U.K. Equities around the Brexit decision, because the asset class is attractively priced, we have a greater margin of safety that should limit our downside. In addition, we would expect the asset class to bounce back well, once the period of fear and volatility passes, as investors renew their focus on more reasonably priced assets. Put simply, valuations will win out in the end. For what it's worth, we view European Equities, in aggregate, as also being relatively attractively priced (albeit slightly less so than U.K. Equities).
- Whilst Friday's market moves are noteworthy, perhaps surprisingly, there is very little change in valuations post these moves. This is because U.K equities have been experiencing heightened volatility for some time in the lead up to the vote.

Indeed, the month-to-date return of the MSCI United Kingdom Index is down a modest 1%, in local currency terms.

- Further, U.K. Equities have gone through a period of depressed earnings, which we would expect to return to more normal levels over time. This has been characterised by declining margins and falling return-on-equity (ROE), particularly regarding the 'Financials', 'Materials' and 'Energy' sectors.
- Fear and uncertainty surrounding the vote has created quite negative sentiment toward equity markets in the region. Being independent investors' means that we can compare our objectively determined valuations with the movements and emotions of the "herd", taking greater comfort in our valuations through an increased margin of safety when our view is contrarian.

Conclusion

Major selloffs often spur a variety of responses by investors. Initially, many become consumed by media accounts of the specific causes, with the negative implications reinforced by the losses in the market. Often that leads to a fear-based response to sell after markets are down in an attempt to avoid future losses. This typically only locks in the current loss and prevents the investor from benefitting from future market gains.

At Morningstar, we make every effort to resist emotional responses and focus on our efforts to find assets that are inexpensive relative to their fair (or 'intrinsic') values. We find that the best opportunities for future gains often come when markets overreact to news and forget that in the long term, prices reflect the future cash flows a security generates. With equities, stock prices should move based on changes in the long-term earnings power of the company.

Whilst it is extremely difficult to predict when this period of volatility will end, we believe that our portfolios are appropriately positioned to achieve their long term objectives, based on our unbiased assessment of valuations and fundamentals. Accordingly, we encourage clients to look through the "noise" knowing that Morningstar's valuation driven asset allocation approach is well positioned to take advantage of any opportunities that may materialise now or in the future.