Talking Points

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For Financial Advisors and Retail Investors using Morningstar's Managed Portfolios

Market Snapshot: Understanding the Brexit Vote

Market Overview

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The United Kingdom has voted to leave the European Union, in a referendum with 52% support for a "Brexit" and nearly 75% voter participation. Prime Minister David Cameron has resigned with a new leader expected before October. What does this mean for investors? In these talking points, we'll review the situation and its effect on investment markets.

As the dust settles following the result of the EU referendum, we thought it would be useful to provide investors with our perspective on the impact of the vote, the outlook for markets and the response of our investment team.

It is clear that we have entered a period of considerable uncertainty that encompasses the whole of the political and economic spectrum. Although the full impact of Brexit will not be known for some time the range of potential outcomes should not be underestimated.

This uncertainty is already being felt in capital markets which have entered a period of extreme volatility with prices moving sharply in both directions. While such episodes always create opportunities for long-term investors who are prepared to think independently, they nevertheless contain dangers for investors. Chief among these is the temptation to react too quickly or with too much confidence in the outcome of this significant event.

Unlike the other recent periods of volatility that have primarily been driven by a change in sentiment, the volatility over the last week has been triggered by an event which could have a significant impact on the long-term growth rate of company profits and hence the fair-value of the shares in those companies. Before considering the opportunity presented by the recent price falls we must therefore first assess the impact on fair value. Without a reasonable assessment of the long-term fair value of these assets, we are unable to conclude whether the new price represents an attractive investment opportunity.

We have prioritised research over reaction in the earliest stage of this event and have not made knee-jerk changes to portfolios. As a result of this approach we have avoided being 'whipsawed' by the sharp falls and the recovery that we have witnessed over the last few days. Consequently, the portfolios we manage have fared well in very challenging conditions.

As we look further ahead, we believe that there are a number of opportunities in the current environment. The first is provided by those asset classes that have experienced steep falls in price but are less likely to suffer directly from Brexit. The most obvious of these is Japanese equities which became significantly cheaper on Friday morning in response to a strengthening of the yen against sterling. While this fall in share prices is understandable, given the importance of yen to the Japanese exports, we expect Brexit to have little impact on Japanese corporate profits over the long term and therefore continue to favour this asset class. We expect several more examples of these assets that have suffered short-term 'collateral damage' to emerge over the coming weeks.

Other opportunities include UK and European assets that have borne the brunt of the Brexit uncertainty. These are potentially the most attractive opportunities but are more challenging to analyse as Brexit may represent a significant change in the fair value of these assets. Consequently, these are also the most dangerous assets in which to invest.

A good example of these latter opportunities are European financial stocks. We had previously identified financial companies (mainly banks and insurance companies) as being attractively priced prior to the referendum and they have subsequently fallen approximately 20%. We are monitoring the sector closely as we anticipate some opportunities may arise here.

As we add undervalued assets to portfolios, we expect to improve the expected return and reduce the potential loss that investors may suffer. However, it is important to note that our approach is inherently long-term in nature and it may therefore take some time before the value inherent in these assets is fully realised. In the meantime, we hold several assets in portfolios which have performed very well in the recent past and appear to be priced above their fair value.

The most obvious of these are government bonds that have experienced a dramatic fall in yields over the year to date. For readers unfamiliar with bonds, they are typically tradeable loans made by governments at a fixed rate of interest. Changes in prevailing interest rates are therefore reflected in the price of these loans. Bonds issued by developed market governments are traditionally regarded as a 'safe haven' asset as these governments seldom default on their obligations. However, this safety comes at a price – low future returns. At present, yields on government bonds are so low that we would expect them to deliver negative real (i.e. after inflation) returns for investors over the next decade. We therefore regard them as fundamentally unattractive on a long-term view.

A further risk arises from foreign currency exposure. Before the referendum, we regarded sterling as being fairly priced compared to the US dollar and euro and under-priced compared to the yen. The recent depreciation of sterling is therefore being monitored closely. However, we will 'tread carefully' as sterling currently appears to be investors preferred vehicle for expressing concern about Brexit and is likely to remain volatile for some time while the market digests the full impact of the unfolding Brexit situation. Any changes made to our Portfolios will be done in the context of a careful balance of long-term risk and reward.

We are also in contact with the managers who run the underlying funds in your portfolio. Each of these managers has been carefully chosen for their experience, expertise and rigorous investment process. We therefore expect them to approach the current situation with a similar long-term, opportunity seeking mind-set.

We appreciate that the current period is very unsettling for our investors and we hope the above provides a useful summary of the work we are undertaking on your behalf. As we move through this period of uncertainty we will do our utmost to keep you and your adviser informed of our latest thinking and will of course update your adviser of any changes that we make to your portfolio. You may also find the Morningstar.co.uk website useful as it provides extensive financial news coverage, detailed analysis and investor education resources.

Should you have any questions or require further information in the meantime, please do not hesitate to contact your adviser.