First State Investments

EXPECTING THE UNEXPECTED: BREXIT

- Brexit: an unexpected headwind for markets, particularly in UK domestic stocks
- Sterling drops 10% following the vote two years ago and doesn't recover
- Lesson learned: diversify portfolio to prepare for further falls in Sterling

The Brexit debate has certainly earned the rare privilege of firing-up British emotion: polarising electorates and government cabinets and turning updates on Brexit negotiations into a weekly soap.

Emotions to one side, it has also had serious ramifications for the UK economy and financial markets. Andrew Harman of the First State Diversified Growth Fund is aware of the risks the impending spectacle will bring and is preparing the portfolio, as far as possible, in order to be able to preserve it against loss of capital - an equally important objective to capital growth for our investors.

The referendum to decide 'Brexit' – a tabloid expression now firmly embedded in the British vernacular – happened on 23rd June 2016.. The next day the pound sold-off 10%. The FTSE-100 dropped likewise in the first few minutes of trading. The initial shock, considering it was a largely unexpected result, caused investors to baulk at the newfound uncertainties around future trade and the stability of the incoming government.

But it wasn't all bad. While UK domestic stocks were being hammered on the Soothsayer's predictions of impacted growth and business confidence, international businesses were seeing a boost to their overseas earnings, and fared much better. In the FTSE-100 around 70% of its collective earnings are overseas, seeing it tending to rise and fall in lockstep with the pound. In a similar vein, Britain's businesses became sudden sale items, attracting a wave of Mergers & Acquisitions.

Time rolled on as the new government set to work. The opaque cloud of Brexit negotiations and minefield Brexit planning meant most companies fell silent for the next two years. But as the cliff-edge approaches the nausea attached to the lack of clarity is more recently forcing them into the open to berate the government more publicly.

Theresa May's recent high stakes summit at her country residence Chequers has attempted to provide some clarity and ended with (most of) the cabinet in agreement with a 'Soft Brexit' proposal: alignment in areas such as goods, customs, and law, with greater flexibility in the movement of people, in setting trade tariffs, and regulation around services. No deal or 'Hard Brexit' seems to be an outcome the government is avoiding, leaving the more hard-line Brexiteers found wanting. With negotiations and interpretations still fluid, details on the UK's position for Brexit will likely remain a moving target.

But what does this mean for our investors? The economic impact is likely hard to predict, but the damage to the pound is maybe more so: in the case of a hard Brexit it could be substantial. This would push up inflation and lower purchasing power, and likely lead to the Bank of England applying the brakes on inflation (and the economy) through raising interest rates.

By stress testing the hard Brexit scenario we believe we have prepared the portfolio, investing in assets to protect against UK inflation as well as using our ability to diversify across the globe and invest overseas. To offset potential spikes in UK inflation we have taken positions in inflation-linked short-dated gilts, where our neutral asset allocation (NAA) is 15%.

To offset potential falls in the pound we have positions in Euros, US Dollars, and other developed market currencies, as well as in emerging currencies such as Turkish Lira. We have also diversified away from positions in UK equities, currently at 7%, to allocate 28% to global equities. Similarly, in government bonds our overseas allocation is 25%, and in credit it's 10% (as at end of May).

Through stress testing we believe we can better prepare for the unexpected: using times where assets have been impacted by certain market events, we can learn from history to avoid the pitfalls that could potentially besiege the portfolio in the future, enabling us to meet our twin objectives of RPI +4% gross over a rolling 5 year period and capital preservation over the short term.

For further information about the First State Diversified Growth Fund click here.

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