In Perspective

The EU Referendum and Your Portfolio

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The market risks of BREXIT may seem material, but they are mitigated by the ownership of robustly structured, well-diversified portfolios.

The impact of a leave vote on your portfolio

As the referendum to remain in, or leave, the European Union draws near, it might be useful to revisit some basic investment principles and to (hopefully) reassure you that your investment portfolio is well positioned to weather any investment storms ahead.

In this note, with the exception of some brief background to help set the scene, we do not seek to analyse the debate, offer political or economic commentary or go into significant detail; rather, we simply seek to raise a number of potential investment-related risks that exist and consider how these might be mitigated by the structure of your portfolio.

How did the UK arrive here?

There is no doubt that the decision UK voters will make is a big one, with material consequences for the long-term nature of who and what we want to be as a nation. It is by no means an easy decision and is made no easier by the polarised positions of both camps, which has resulted in unedifying personal attacks, the loose use of data, scarcely concealed personal ambition, party division, the blurring of the lines between opinion and fact and even an element of wilful scaremongering.

Today's referendum is a long way from the heady days of 1973 when the UK – urged on by Ted Heath – became a fully paid-up member of the European Economic Community (EEC), by an emphatic margin of two to one. It may surprise some that back then those pushing for entry were the Tories and it was the Labour Party that was riven with in-fighting. Thatcher's EU budget rebate in 1985 – which still rankles with some – and our short-lived membership of the Exchange Rate Mechanism, which came to an abrupt end in in 1992, were early milestones in the up-and-down relationship between the UK and the EU.

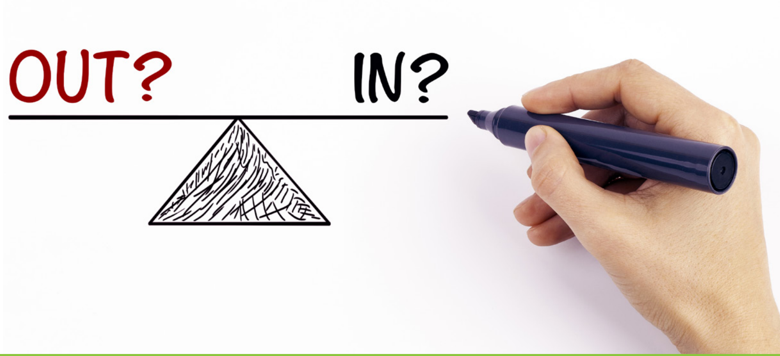
50 shades of grey

Whether the EU has been a success to date or not very much depends on one's point of view and while many have a very black or white take on all matters EU, plenty, perhaps the majority, see the EU and its merits, achievements and shortcomings as several shades of grey.

As such, even the most fervent Europhile probably wouldn't deny the EU has had – and continues to have – plenty of faults and challenges, including the well-known bureaucracy, the future of the Euro and coping with mass migration, but equally, even the most ardent Eurosceptic would probably recognise that, in all of its guises since the Treaty of Rome in 1957, the EU has been central to co-operation and peace between the nations of Europe, which, bearing in mind the history of the decades – indeed, centuries – preceding 1957, is no small achievement.

So, what about my portfolio?

Much has been written in the financial media about the need to position portfolios for a vote to leave the EU (BREXIT). Yet this presupposes that any of us, can, in some way, foresee what is going to occur and thus reposition a portfolio accordingly. It also presupposes that BREXIT is a bigger risk to your portfolio than, say, Putin's increasing militarism, the enduring tragedy of events in the Middle East, North Korea's nuclear sabre-rattling, Donald Trump becoming the next US president, or some other geo-political event, act of terrorism or natural disaster that cannot be foreseen.



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When your portfolio was established, it was in your and our knowledge that any number of such events could – and would – occur with monotonous regularity over the years. The aim therefore is not to try to reposition your portfolio for each such event – remembering both that the market's view of potential outcomes is already reflected to some extent in market prices, and that market timing is proven to be a wealth destroying fool's errand – but to build a robust, well-diversified portfolio at an appropriate and personalised level of risk, which is capable of weathering, or benefitting from, all investment seasons.

This being said, it is clear there are some short-term market risks inherent in a vote to leave the EU, and these are worth understanding:

Risk 1: Greater volatility in the UK (and other) equity market(s)

It is certainly possible that the UK equity market could suffer increased volatility / falls in value, as the market tries to come to terms with what a vote to leave means for both the UK economy and the wider global economy.

Risk 2: A fall in Sterling against other currencies

Much has been made of a fall in Sterling against other global currencies, which has already been reflected to some degree in exchange rate movements since the start of 2016. For example, at the time of writing, Sterling has fallen from 1.48 against the US dollar to 1.45 and from 1.36 to 1.27 against the Euro.

Risk 3: A rise in UK bond yields (a fall in bond prices)

The Chancellor, amongst others, has stated that the cost of borrowing might rise as investors looking to hold bonds issued by the UK Government (and UK corporations), will demand higher yields on these bonds in compensation for the greater perceived risks, vis-a-vis the uncertainty surrounding the decision to leave the EU.

Looked at in isolation, these may appear to be significant risks. However, as part of a well-diversified and sensibly constructed portfolio, their impact can be greatly reduced.

Mitigant 1: Global diversification of equity exposure

It is worth remembering that the UK economy represents less than 5% of global GDP, and its equity market currently represents around 6% of global market capitalisation. The stock market is also not a direct proxy for the UK economy, as many of its constituents, such as HSBC and Shell, have considerable overseas operations. In fact, around 70% of earnings from FTSE 100 companies come from overseas.

Your portfolio has well-diversified exposure to other developed equity markets (e.g. the US, Japan, Germany and Australia) and emerging markets economies and companies (e.g. Taiwan, China, India and South Korea), which will help to mitigate any UK-specific market fall. Equity markets as a whole might be volatile, but that is the nature of equity investing and as ever, being diversified will help.

 

Mitigant 2: Owning non-Sterling assets and currencies within your growth assets

In the event that Sterling takes a beating, it is worth remembering that the overseas equities that you own come with the currency exposure linked to those assets. For example, owning US equities comes with US dollar exposure, as the dollar exposure is not hedged out. If the Pound falls, for example, against the US dollar, these US assets would be worth more in Sterling terms, thus to some extent helping to mitigate the fall in Sterling. In short, a fall in Sterling has a positive effect on non-UK assets that are unhedged.

(The bond element of your portfolio has no non-Sterling currency exposure, to avoid mixing the higher volatility of currency movements with the lower volatility desired of, and delivered by, short-dated bonds).

Mitigant 3: Owning short-dated, high quality, globally diversified bonds

The primary defensive assets in your portfolio are short-dated, high quality bonds, diversified on a global basis. Short-dated bonds are less volatile than longer-dated bonds and their prices will be less affected by any rise in yields. Indeed, high quality bonds tend to be where money flows to at times of equity market trauma, which, in the short term at least, tends to drive yields down and prices up. Your bond holdings are also diversified across a number of different global bond markets, which mitigates the risk of a rise in UK yields / falling prices, as the cost of borrowing in other markets will not be impacted in the same way.

Sticking to your strategy

At times like this, it is easy to become overly concerned about near-term events, such as the outcome of the EU referendum. Your life as an investor will inevitably be punctuated by an ongoing series of near-term events, which have the potential to make life continually uncomfortable – unless, that is, you view them in context and remember both that market movements are an expected (and compensated for) part of the investor journey, and that your Financial Plan is robustly structured and regularly revisited to minimise the risk of these events fundamentally compromising your financial future.

As such, it would be worth remembering that:

- The value of your portfolio simply tells you how much money you would have if you liquidated your entire portfolio today – which, of course, you have no intention of doing.
- Your portfolio has a well-thought-out structure that has been designed to provide you with the best chance of a favourable long-term investment experience.
- Some assets will be doing well at times and others less so. No-one knows which asset(s) it will be at any point in time. Markets work well enough to make jumping from one asset class to another a dangerous gambling strategy, proven to destroy wealth.
- Markets will do what they do and no-one can control or consistently outsmart them. Evidence informs us as to broadly what might be reasonable expectations of future portfolio behaviour characteristics and as such, we know there will be times of volatility and falls in value, which are simply the price you pay for the higher expected long-term returns of bonds and equites versus cash and inflation.

In summary, whether your inclination is to remain or leave, keep in mind both that your portfolio is well-positioned to weather any storms and, more importantly, that if a storm does head our way, as the investment sage John Bogle has said many times at other seemingly concerning moments, 'This too shall pass'.

Best regards

Michael

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In addition to being a Chartered Wealth Manager, Michael is a Chartered Financial Planner and holds the globally recognised Certified Financial Planner qualification. He is also a Fellow of both the Personal Finance Society and the Chartered Institute for Securities & Investment and as such, is one of the most highly qualified financial planning professionals in the UK. Michael also sits on Chamberlyns' Investment Committee and helps to produce the firm's regular series of concise 'In Perspective' articles, which consider, and provide perspective on, a range of current and timeless wealth planning issues.

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