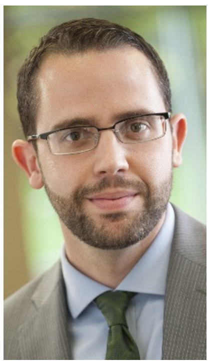
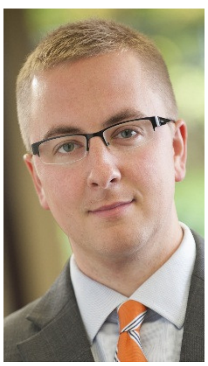
**Brexit** **June 2016**

Michael D. Axel, CFA



Jacob D. Benedict, CFA



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Last Thursday, a majority of voters in the United Kingdom cast their ballots in favor of leaving the European Union (EU). Though the margin was small – 52% to 48% – the impact on financial markets was pronounced. At the time of this writing, foreign developed stock markets have dropped by over 10% (in U.S. dollar terms) and U.S. stocks have fallen by over 5%.[1] Interest rates across the globe dropped, with the 10-year U.S. Treasury yield falling below 1.5%. Most major European countries have even lower rates, with Germany and Switzerland in negative territory.[2] The British Pound hit a three-decade low.

Part of the dramatic reaction in markets can be explained by the fact that it was a surprise. Although pre-vote polls had shown the "leave" campaign gaining some ground, commentators and the markets remained confident that the referendum would be defeated. The vast majority of British politicians, world leaders, and company executives favored remaining in the EU. Indeed, markets rallied earlier in the week on the back of increased confidence in the outcome. And although markets have grown volatile, global stocks still remain around 5% above the lows hit in February.[3]

At this point there are many more questions than answers. The vote introduced a lot of uncertainty into both the economy and the markets, and business executives and investors loathe uncertainty. The path forward for the U.K. is unclear. Prime Minister David Cameron resigned and the country must start the potentially excruciating prospect of negotiating new trade agreements with European and global trading partners. Businesses may be forced to relocate employees and even whole business segments from the U.K. to a remaining EU-member in order to freely trade with remaining EU members. Scotland's First Minister suggested her country may try to veto the proposed exit, and polls show that both Scotland and Northern Ireland may now seek independence from England (both countries favored remaining in the EU). News articles suggested that some U.K. voters reacted with regret as they observed the impact of the vote and movements began to re-vote the referendum. Investors are probably most concerned with whether the U.K.'s vote will empower separatist movements in other European countries to successfully push for their own referendums, which could signal serious problems for the survival of the EU.

[1] As measured by the S&P 500 and the MSCI EAFE indexes.
[2] Bloomberg Markets, "Rates & Bonds." Accessed June 27, 2016.
[3] As indicated by the Vanguard Global Stock Market ETF.

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The EU is a good idea, but the U.K.'s vote throws further light on flaws that have been apparent for some time. The original impetus for the EU was noble – to stop European countries from warring with one another. Over time, it became apparent that there were notable economic benefits to a "single market" as well. But unions are hard. Just look at the extremely bumpy road traveled by the United States as we tried to meld thirteen original colonies into a single union (the Civil War being the harshest example). The EU tried to have it all – a monetary union with a single trading market and the free flow of people, capital, and goods across borders, but without sacrificing member countries' fiscal sovereignty. But as your grandmother may have warned, you can't have your cake and eat it too. This arrangement has led to serious strains, which burst onto the scene with Greece's debt crisis several years ago. The EU seems to be faced with a tough decision: either come together in a more tightly aligned union, or risk breaking up. So far, EU policymakers have tried to muddle along. But the weak economic recovery since the global financial crisis as well as the current refugee crisis in Europe fanned voter discontent. (Sound familiar?) Now, EU policymakers may be forced to act more decisively.

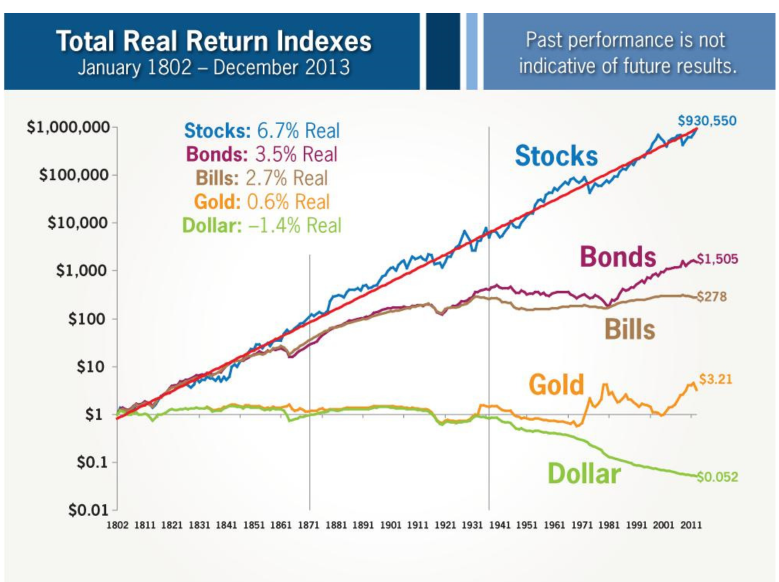
What does this mean for the global economy and stock prices? As you might imagine, it's incredibly difficult to know. Consider two paths:

- The U.K. transition is reversed (unlikely) or proceeds smoothly with favorable negotiations with the EU, and the rest of the EU comes together in a stronger union.

- The U.K. vote fans separatist movements in other EU countries. Global trade faces sustained headwinds. Worried about all of the uncertainty, consumers cut back on spending and executives cut back on capital investment, weakening the global economy.

We, nor do we think anyone else, knows what will happen. The end result will probably be somewhere in the middle. But the key question is what will the productive capacity of the economy be ten years from now? That will determine where stock prices are, and while the U.K. vote may hamper that a bit by constructing additional trade barriers and holding back productive investments, we don't think it makes sense to bet against the U.S. or global economy.

We don't mean to downplay the risks that face the global economy. We've been discussing these for several years now. But we do think it's important to put these risks into perspective. It's easy to focus on the challenges the economy faces and become downtrodden. Yet Warren Buffett likes to point out that he bought his first stock right after Japan bombed Pearl Harbor. And although the world has faced many challenges, the investor that held on to his stock investments has done very well, and much better than the investor who camped out in cash or bonds. U.S. stocks have crushed the alternatives over the past 200+ years:[4]

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[4] Jeremey Siegel.

Now it's tempting to think that the investor can jump in and out of the stock market and do even better. We've seen almost no one be successful at that on a consistent basis. Every day the investor is faced with events that could affect stock prices. Take the recent Brexit vote. If the referendum had failed, as was widely expected, stock markets would have very likely jumped higher. Because the referendum succeeded, markets sold off. Investors who try to play this game – betting on these discrete, hard-to-predict events – will get some right and some wrong, but over the long-term they will very likely be worse off, as the expenses of the game far outweigh the benefits. In ten to fifteen years we believe stock prices will be higher and that the costs of trying to jump into and out of markets leave that type of investor worse off.

A close friend once ribbed us, saying that he enjoys reading our missives but often finds that they are just different ways of communicating the same basic premise – "stay the course." There is truth to this. We strongly believe in a long-term commitment to diversified, low-cost, "stay the course" investing. Indeed, a large part of our value-add is often derived from helping our clients keep their heads when everyone around them seems to be losing theirs. Does this mean we would never advocate an action such as cutting stock exposure in order to protect portfolios?

No. We believe that investors might want to consider reducing their stock exposure when *stock prices are exceedingly high*. Is that the case now? We don't believe so. We believe high-quality companies, including leading finance and industrial franchises, are priced relatively cheap. In a world where cash offers nothing, high-quality bonds offer just 1-2%, but high-quality stocks might yield 3% or more, does it really make sense to sell stocks? This doesn't mean stocks can't go down or that stocks will do great from here. It's a tough environment and global growth is slow. But we still favor owning productive assets like high-quality businesses. Yet if we believed that stock prices were exceedingly high or that we could get similar returns in lower-risk investments like bonds, we would strongly consider taking action.

Finally, the Brexit vote highlights another thorny question – how much should a U.S. investor invest in international stocks? We've been working on a white paper that tackles this issue and look forward to sharing it with you soon. There's no simple answer. In preview:

- Financial theory suggests that U.S. investors should be indifferent between domestic and foreign stocks, and many institutions invest around 50% of their stock portfolio in U.S. stocks and the other half in foreign stocks. Investors we highly respect are split on the issue, with some heavily favoring international stocks and others avoiding them completely.
- We've historically been more partial to U.S. stocks, and typically invest 75-80% of our stock portfolio in domestic stocks, split between developed and emerging markets. Our U.S.-bias benefitted us over the last several years but it isn't based on some prognostication that U.S. stocks would do better. Instead, our reasoning includes:
  - Many U.S. companies offer international exposure (companies in the S&P 500 register nearly half of their sales in foreign markets[5]).
  - We agree with Charlie Munger, Warren Buffett's longtime business partner, that the U.S. is a particularly attractive place to invest, with strong protections and competent management.[6]
  - As markets have become more globalized and correlated, the diversification benefits of international stocks have dropped.
  - Many U.S. investors have liabilities denominated in U.S. dollars, so they don't need currency diversification.
  - Investing in foreign stocks often entails slightly higher expense ratios.
  - We simply know the U.S. better. This doesn't mean it will do better, but it's usually a good idea to stick to games you know.
- Why, then, don't we invest 100% in U.S. stocks?
  - Well, history shows real diversification benefits from international stocks and foreign currencies. An insightful study by Vanguard illustrated that a globally diversified portfolio has actually had *lower* risk

[5] Silverblatt, Howard (contributor). "S&P 500 2013: Global Sales Year in Review." *S&P Dow Jones Indices Research*. August 2014.
[6] Munger, Charles. "Investment Practices of Leading Charitable Foundations." Speech given at a meeting of the Foundation Financial Officers Group. October 14, 1998.

than a purely domestic one. Vanguard concludes: "Although there is no right answer for all investors, empirical and practical considerations suggest a reasonable starting allocation to non-U.S. stocks of 20%, with an upper limit based on global market capitalization [i.e. ~50%]."[7] (As you can see, we take the lower limit of their recommendation.)

- Many global companies are no different than their domestic competitors, and it doesn't seem prudent to ignore them.
- Foreign stocks provide some useful hedges to U.S. investors. For instance, if domestic inflation spiked, the dollar would fall, and foreign stocks could do comparatively better.
- Even if emerging markets grow faster than the U.S., research shows this doesn't mean their stock markets will perform better. However, we do believe emerging markets offer some interesting investment opportunities longer-term as they transition into more developed economies.

Does the Brexit change our opinion? It does reveal some of the major challenges the EU faces. And China has its own struggles. But these challenges are also reflected in lower stock valuations and potentially depressed currencies. We continue to favor investing in the U.S., and 80-90% of our total stock/bond portfolios are U.S.-based, but we still think some international diversification makes sense longer-term.

If you have any questions, please don't hesitate to contact us.

[7] "Considerations for investing in non-U.S. equities," by Christopher B. Philips, CFA, Vanguard, March 2012.