Smart[im]: Important Information – Portfolio positioning ahead of the referendum

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Smart Investment Management

Brexit and the potential implications for investors

In recent days the momentum in opinion polls has moved in favour of Brexit, with several polls putting the Leave camp ahead, albeit with the number of voters undecided remaining sufficiently large to swing it either way. Bookmakers still believe that a Remain vote is the more likely outcome, with their confidence based apparently on the belief that uncertain voters tend to vote for the status quo when stood in the polling booth. However, the odds for a Leave win have changed markedly, from 11/4 as recently as last Friday to 13/8 at the time of writing, by far the shortest odds since the campaign began.

It remains to be seen whether the polls or the bookmakers turn out to be more accurate. However, what is clear is that the vote is too close to call with any degree of confidence so it is more important than ever to consider the impact that either outcome will have on our portfolios.

A Leave vote would be expected to lead to steep falls in both the value of sterling and the UK stock market, as investors hate uncertainty and there would be many variables relating to the exit negotiations. In addition, there is a strong possibility of risk assets suffering across the board and equities falling globally, with European equities seeming most at risk of such contagion, whilst safe haven assets, such as US Treasuries, would be expected to rise. However, the degree and length of such falls, and the size of any possible rebounds, are hard to predict, as is the amount to which central banks might step in to calm nerves.

A Remain vote would be expected to produce the almost exact opposite, with a short and swift relief rally in the value of sterling and markets globally responding positively to such an outcome, with sterling assets benefiting from an additional lift. On the flip side, safe haven assets might struggle, as investors sell positions that they have accumulated to protect against a Leave vote.

Whilst the two outcomes are almost polar opposites in terms of direction, we believe that the size of the likely market movements in either event are likely to be significantly different and this asymmetric risk, with the downside risks to investors being much greater than the potential upside, is a concern with the outcome of the vote so uncertain.

What have we done to mitigate the risks in the sterling portfolios?

Most of our equity exposure is held in non-sterling assets so, should the UK vote to leave and sterling falls sharply, holding equities in international currencies, particularly the US dollar, should provide the portfolios with a hedge against falling equity markets. Therefore, as most strategists are forecasting that sterling will bear the brunt of any 'risk off' scenario, it is not inconceivable that sterling investors could profit from holding overseas equities, even if they fall in value as well.

Whilst they contain a higher amount of UK exposure, our non-equity holdings are also well diversified globally so enjoy protection through the same mechanism, albeit it to a lesser degree.

However, in line with our focus on downside protection and with the degree of contagion across markets after a Leave vote being impossible to predict, we have decided that a significant cash buffer is desirable in advance of the vote. This provides an obvious protection against falling asset prices but has the additional benefit of allowing us to deploy the cash after the result to buy whichever asset classes fall and offer the most attractive opportunities.

In the higher risk portfolios, where the bulk of the portfolio is in equities, we have generated the cash by moving to an underweight equity position overall by reducing our exposure to US and European equities. We have chosen these two areas

for very different reasons. US equities have held up well year to date and we perceive the upside to be limited in the event of a Remain vote, especially as a US interest rate rise could be around the corner in July following such an outcome. European equities and the euro are potentially more vulnerable to contagion in the event of a vote to leave than other equity markets, especially if investors questioned the viability of the European project. Therefore, whilst we are maintaining an overweight position in European equities as we believe that they continue to offer value, especially with the ongoing support of the ECB's loose monetary conditions, we have decided that it is prudent to reduce the size of the overweight.

In the lower risk portfolios, we have generated the cash by moving from overweight to underweight positions in Strategic Bonds and reducing our overweight to Absolute Return. Strategic Bond funds have enjoyed a good run, as the ECB decision to include investment grade corporate bonds within its quantitative easing programme having caused a material tightening of spreads in corporate credit. Therefore, when taking into account the higher correlation that they have to equities compared to Government bonds, we believe that reducing this area is prudent. Absolute Return provides uncorrelated returns that are attractive within the portfolio but, over a short period of time in a market that may be highly volatile, how they behave will be impossible to predict.

In the portfolios that sit in the middle of the risk spectrum, we will be raising cash using both methods in combination.

For the higher risk portfolios in which we are reducing our exposure to US equities, we have invested the proceeds into US dollar cash, as we do not want to reduce our exposure to the currency and the currency hedge that it provides against a sharp sell-off in sterling. For the lower risk portfolios, where we are not selling down that exposure, we will be holding the money in sterling cash.

What have we done to mitigate the risks in the EURO portfolios?

We see the risks for euro investors as broadly similar to sterling investors so have taken similar steps to protect against both possible outcomes. Our exposure within the portfolios to European and UK equities is through Pan European funds, so we have less exposure to sterling than within the sterling portfolios. However, the potential for European assets and the euro itself to get caught up in any sell off after a Leave vote is very real and, whilst we would expect the ECB to step in and support markets if they felt that things were getting out of hand, the fact that they would probably welcome a weaker euro might constrain any response. Therefore, moving to an underweight position in the higher risk portfolios whilst increasing diversification away from sterling and euro assets seems prudent, whilst in the lower risk portfolios we are raising the cash from Strategic Bond and Absolute Return funds and a blend of both trades in the medium risk portfolios.

This cash will be parked predominantly in US dollar cash as a further hedge against a sharp sell-off in the euro.

What have we done to mitigate the risks in the DOLLAR portfolios?

For US dollar investors with exposure to international assets, the risk outlook is very different. Whilst both sterling and euro investors have the comfort of the US dollar acting like a natural currency hedge, the reverse is true for US investors and, in the event of a Leave vote, those holding UK and European assets would be likely to face the 'double whammy' of falling equity prices and falling currencies. The strategic asset allocation within the US dollar portfolios controls this currency risk by having a higher allocation to US equities and, therefore, less to European/UK equities compared to the sterling and euro portfolios. However, the exposure to the latter is still significant so, in the higher risk portfolios, we have taken the decision to go underweight equities as well as moving underweight Europe and the UK in favour of the US. Furthermore, we have hedged half the currency risk of the remaining pan European equity exposure back into US dollars. As with the sterling and euro portfolios, we have raised cash at the lower end of the risk spectrum by selling down Strategic Bond and Absolute Return funds and a blend of both strategies for the portfolios in the middle of the risk spectrum.

This cash will be parked in US dollar cash avoiding any exposure to sterling or the euro.

What have we done to mitigate the risks in the SMARTFUNDS?

The base currency within the Smartfunds is sterling so we are able to benefit from natural currency hedging by holding non-sterling assets in the same way as the sterling portfolios. In order to maximise that protection, we have removed the currency hedges to sterling that we had in place. The other steps that we have taken are similar to the sterling portfolios, having reduced equity in the balanced and growth funds whilst reducing exposure to corporate credit.

How the protected and the non-protected portfolio perform over the next few weeks will very much depend on what happens to volatility from here and whether exposure is reduced further. The protected fund automatically has less market exposure due to the embedded put option and therefore if markets perform poorly over the next few days, we would expect the protected fund to provide greater protection versus the unprotected fund. The extent to which performance diverges will depend on how much the volatility overlay has reduced exposure ahead of any such market loss event. On the flip side, in the event of a Remain vote, the unprotected fund will have less drag if markets rise.

What will we do after the event?

Whilst we have laid out our expectations for how assets might behave immediately after a vote to Leave, it is impossible to know the quantum of such moves, and this is reflected in the wide range of views amongst well-respected market strategists. Predictions have ranged from markets settling down within a matter of days, calmed by co-ordinated central bank intervention, to a fall in the value of sterling of over 30%. We cannot be any more certain than anyone else but we think that the most likely outcome is a sharp fall in sterling combined with a sharp selloff in UK equities and an element of global contagion. However, whatever the actual outcome and effects on markets, the 'cash buffer' allows us to invest in the most attractive assets for the least risk in the days and weeks after the vote when we can judge exactly where the opportunities lie.