LORING WARD

Special Investment Committee Report

FAQ on Brexit & the Markets

What was "Brexit" and why did it happen?

Brexit (short for "British Exit") was the nickname given to the movement to persuade the British government to pull Britain out of the European Union (EU). A nationwide referendum — only the third in modern history in Britain — took place on June 23, 2016, and by a close vote of 52% to 48% British voters asked their government to negotiate a deal to leave the EU.

The idea of creating a single, common market across Europe began in the aftermath of World War II. A slow effort, but by 1993, a single market was created covering 28 countries. Borders were opened and visas for travel and work permits abolished. An important milestone was the development of the European Monetary Union in 1999 which, by 2002, had converted 19 of the 28 countries (defined as the "eurozone") over to a single currency, the euro. Britain was a party to the EU, but it did not choose to participate in the eurozone, and thus preserved its use of its home currency, the pound.

While Britain, like most of the other EU countries, benefited economically from a common market, Britain has never been as comfortable with some of the political aspects of the EU. Long-term immigration trends and their recent acceleration under the EU have stoked strong nationalist feelings in Britain, leading to the political movement to exit the EU.

Why the strong market reaction to the Brexit outcome?

Markets don't like to be surprised. For weeks polls (and other prediction markets, such as bookies) suggested that by a narrow margin voters would opt to keep the U.K. in the EU. When the opposite happened, global markets reacted negatively based on four potential and highly speculative concerns:

1. Slower Economic Growth — The EU was an economic success and a British pullout may possibly lower global trade and economic growth.
2. Spread of the Brexit Sentiment — The political fallout is less predictable. If other European countries, especially eurozone members, consider voting for their own form of "Brexit," a far more precipitous economic change could occur, especially if the euro loses credibility as a currency.
3. Fears of a Banking Crisis — Some investors are concerned that European banks, whose vulnerabilities have been made clear in prior challenges dealing with Greece and other weaker eurozone members, may not be fully prepared for the British exit or for a wider breakdown of the EU.
4. Contagion to Non-EU Countries — The monetary and fiscal policies of the EU have the potential to affect non-EU countries, including the U.S. and Asia.

The EU and eurozone banks have floated a wide array of euro-denominated government bonds, held by investors worldwide, which could be impacted.

Again, these are all potential — not actual — concerns. And uncertainty about whether or not they might come to pass may contribute to short-term volatility.

How does Brexit affect my portfolio?

The impact of the Brexit vote on financial markets is driven far more by the uncertainty and the unknown than by certainty and what is known. When similar global events have occurred historically, we have seen:

- Flight to Quality — Institutional investors, especially those with leveraged or short positions, will often liquidate such positions and temporarily purchase "flight-to-safety" or "safe haven" investments such as Treasuries, yen- and dollar-denominated assets. History has shown us, however, that flights to quality are almost always temporary and should not be mimicked by retail investors who do not face the driving pressures of leverage and borrowed securities
- Impact on Interest Rates — The yields on bonds most closely connected to the crisis (e.g. euro-denominated bonds) are likely to rise as institutional investors step away from them until a clearer future is on the horizon. U.S. bonds often rally (yields falling) — especially in the shorter end of the U.S. yield curve — as investors seek a safe haven. And finally, various global central banks — most notably the Federal Reserve — have been known to temporarily provide liquidity (i.e. ease) during the initial reactions to such global events. As for corporate bonds, the impact will be scattered based on how much exposure a given firm has to events in Europe
- Impact on Stocks — Markets are really big information processing centers that tend to dislike uncertainty and invariably do not react well to surprises. Stocks will also react negatively when a global economic slowdown is a possibility

As we discussed and analyzed in last quarter's *Investment Committee Briefing on Volatility Clustering*, events such as Brexit often form the starting point, the initial volatility event, for a Volatility Cluster. Such Clusters can last weeks, perhaps upwards of a handful of months. During such Clusters, the stock markets are much more likely to see sharp, single-day declines than single-day recoveries, and to drift lower across the period of the Cluster. Volatility Clusters, historically, have been temporary; however, timing their end is next to impossible.

What changes to long-term portfolios does Loring Ward recommend to deal with Brexit?

Our investment philosophy has long held that political events such as Brexit are unpredictable — as are their future investment implications. In the long run, these events do not impact wealth accumulation because they are fully priced into the markets day-over-day even as they change. In the short run, yes, they do mean periods of uncomfortable volatility, but that's it. Given that neither their occurrence

nor the longevity nor the direction of the market reaction can be predicted, we do not find a need to change our international exposures as a result. Our models typically have about 6% exposure to the U.K. and about 13% to the rest of Europe, excluding Britain. Relative to the world market, our exposure is slightly lower to the U.K. and to Europe.

U.S. companies have limited direct exposure to Europe. According to FactSet, only 2.9% of S&P 500 companies' revenues come from the U.K. and just 7% of revenues from Europe as a whole.

Events like Brexit are precisely why we believe in broad global diversification, with 9 asset classes representing 10,000 securities in 45 countries and 35 currencies.

Investors who try to predict the unpredictable before it happens — or react to events after financial markets have already rendered their verdict — will invariably turn temporary declines into permanent losses. Investors who ride out the storm will experience the same uncomfortable volatility, but their losses will be unrealized and, therefore, likely to be temporary. Thus, investors who stay the course are more likely to reach a higher point of long-term wealth accumulation. Staying the course and not panicking can have a major impact on long-term portfolio growth.

When does Loring Ward think markets will return to "normal?"

Unusual market events, such as the Brexit vote, are actually "normal," but not necessarily frequent.

Here's what we know today:

The "Brexit" will take two years, or more, to complete.

A number of economically successful European countries, such as Switzerland and Norway, are not members of the EU.

Financial markets are far more resilient in the long run than it often appears while we are in the depths of a short-term Volatility Cluster.

We do not try to predict when Volatility Clusters are going to come to an end in the same spirit that we do not try to predict when the triggering volatility events will occur either. We cannot say how much lower markets will go, or when they will recover. We cannot predict which countries will do well and which will not, nor which securities will benefit and which will decline. And despite what some prognosticators claim, no one knows exactly what the future holds in store.

However, based on historical events, we believe that these kind of events eventually assimilate within a window of anywhere from 2 weeks to 6 months. Any greater level of precision in analysis is wholly unreliable. Keep in mind:

1. **This is a prime example of market efficiency in action.** Well-functioning markets quickly assimilate new information into securities markets. Also, given the unprecedented nature of this event, new information will likely continue to be assimilated into securities markets as the U.K. negotiates the terms of their exit from the EU.

2. **Patient investors who ride out such volatility events tend to experience higher long-term wealth accumulation than those who seek to predict and act upon the start or the end of such events.** Given the efficiency of global financial markets, reacting to the events after they have occurred only ensures that a portfolio repeatedly "buys high and sells low."

3. **Rebalancing can make a difference.** By rebalancing portfolios regularly, we strive to "buy low and sell high" as we focus on making sure each portfolio stays allocated to the desired long-term mix of stocks and bonds.

4. **Great risk brings the potential for higher expected returns.** While many commentators are focusing on the increased expected risks of investing in the U.K. and Europe, they are ignoring the potential for increased expected returns. When an investment's risks rise, investors should expect the return potential to rise as well.

5. **Political risks are not the same as investment risks.** For example, the top performing global market over the last 10 years was the Philippines, which has experienced political turmoil as well as an active guerilla insurgency. On the other hand, a peaceful, stable country like Canada was all the way down at 30th in terms of performance.

Our advice in the face of such events is to take comfort in the longer run of history, which has faced far worse volatility-aggravating events than this, including several recessions, stagflation, the Great Depression and two world wars.