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Ken Stern & Associates
A Registered Investment Advisor

VOLATILITY CATALYST DU JOUR: BREXIT

By Kenneth Stern, CFP®

Volatility in the markets can be caused by any number of conditions. At Ken Stern & Associates, we believe that regardless of the cause du jour of market volatility, portfolios should be actively managed to embrace volatility rather than fear it. Markets move, in part, due to the anticipated impact an event or future event may have. Markets also move radically in either direction as a result of emotions. With this knowledge, instead of fearing the next crisis or reason for volatility, we embrace and plan for markets to act and react. Some advisors advise their clients to "stay the course" during difficult market cycles; we don't subscribe to this passive view.

If we believe factors have led markets to a level that is irrationally in excess, we seek to reduce our exposure to these markets. To accomplish a reduction in risk exposure we may seek to invest in assets that are not tied to volatile liquid markets. Often illiquid investments are less correlated to day to day market activity. We may also move to increase income producing assets, focusing on interest and dividends. We can raise cash to reduce volatility. We can also look to improve the credit quality of bonds or manage the duration of a fixed income portfolio. There are various hedging techniques that can be utilized to add a level of security. Today, for example, many of our portfolios are diversified and holding elevated levels of cash, low correlated assets, and underweight exposure to international and emerging markets.

We seek to prudently capitalize on volatility. When markets categorically sell-off, there are pockets of strength. We seek the opportunities created by this volatility. Great Britain exiting the European Union is a perfect example of this possibility. ***What opportunities might be created by this transition?***

The European Union and the Brexit Vote

Think of the European Union as a group of countries that agree to align political and economic interests, such as open borders and free trade among the 28 member countries. Members trade freely and there are also central banking and lending facilities. As a result of the Union, the cost of doing business across member countries throughout Europe have dropped.

There are, of course, downsides to Union membership. There are significant costs and fees to be included in the Union and member countries pay into a savings fund. This fund might help lend to other countries in the European Union, pay for common public works, and/or provide economic relief. Free trade and open borders are generally beneficial, but can also have a negative impact if immigrant populations grow at a cost and stress to the economy.

Here is some information on the Brexit vote from this week's Stern Word newsletter, by Ken Stern & Associates' own Christopher Peterson:

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"Britain's surprising vote to leave the European Union, known as Brexit, drew plenty of attention, especially when Friday saw both the S&P 500 and Dow Jones Industrial Average plummet over three percent in the aftermath; probably not the type of summer excitement people were expecting less than a week after officially entering the season.

Britain's exit was decided by a vote of 51.9 percent to 48.1 percent. Areas that have benefited most from being in the European Union, such as London and Scotland voted heavily in favor of remaining part of the union, but could not outweigh the other parts of England. Age was also an area showing a difference in voting as 75 percent of voters younger than 24 wanted to remain, while 58 percent of voters over age 65 wanted to leave, according to the Los Angeles Times.

The primary areas of contention for the vote to leave or remain were the state of the economy and immigration. An article in The Economist stated that 'despite repeated warnings from an alphabet soup of national and international bodies that the economy would suffer as Brexit led to lower trade, less investment and lower growth, many voters were unimpressed because they did not feel the economy worked for them now.' Supporters of Brexit were also able to lean on fears of migration to the U.K. Those pushing to remain part of the union 'failed to convince voters that EU migrants brought economic benefits, or to explain that more than half the 330,000 net immigrants in 2015 came from outside the EU,' according to the same article.

It is still a bit unclear what will happen next, as no country has ever decided to leave the European Union before now. The legal path of exiting the European Union would include invoking Article 50 of the Lisbon treaty. The Economist explains that Article 50 'provides that the terms on which Britain leaves must be agreed by a majority of the EU's other 27 members, without a British vote. It sets a two-year deadline that can be extended only by unanimity.' The terms of Article 50 are not necessarily in favor of Brexit, so likely there will be long and drawn out negotiations before much of the dust settles.

The uncertainties surrounding Britain voting to exit the European Union will likely lead to continued volatility in the markets while the global economy adjusts to the news and while terms of the exit begin to be negotiated. Cash flow producing investments and tactical strategies will continue to create potential areas of opportunity within a portfolio through the summer and current market conditions."

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What does this mean?

A nation opting to leave the EU is unprecedented, thus it is uncertain what the true impact of Britain's leaving the European Union will have. Investors that had been using Great Britain as a gateway to trade throughout Europe may refrain from future investment. This could cause slower growth within Great Britain. Further, Great Britain was a large and important contributor to the Union. How will their exit impact the viability of the EU? If other EU members follow suit and leave, will this take us back to a fractured Europe? Could smaller debt ridden nations like Greece, Italy or Spain decide to leave? If they do, would there be chance their debt becomes a burden for remaining members like Germany? Germany has been tremendous growth engine for Europe; if their debt and economic prosperity is compromised, this could have a disastrous impact on economic prosperity throughout Europe.

Given these negative potential scenarios, the market did as it does: shoot first and sort it out later. Markets don't like uncertainty, and, as a result, will take a scenario and discount the current value based on a potential future event. Add a visceral emotional response as well, and market disruption occurs.

Are the scenarios outlined above possible? Of course. Yet this also creates potential for both Great Britain and the EU to prosper. Innovation will likely continue to be a force for further growth and expansion. One could argue that Great Britain was paying more than their fair share to be part of the EU, and that the open borders were more costly to Great Britain than they were beneficial. Knowing that foreign investment may temporarily slow in Great Britain, banks may have to lower interest rates which could foster further growth.

Europe seems to have more questions than answers at the moment. The current tepid growth concerns everyone. Expect volatility to continue and expect downward pressure. Uncertainty and unrest can result in selling; as a result, it may soon be time to go fishing in the value barrel. There have been several strong financial, healthcare, and industrial companies that were on our "wish list" but have been out of reach from a valuation perspective. Could the Brexit be an opportunity to add names to our investment list that were formerly on the wish list? One man's weed is another man's flower.

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