Investment Insights
Countdown to Brexit

BESSEMER TRUST

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Highlights

- The political climate and market volatility are intensifying in the lead-up to the June 23 Brexit vote.
- While recent polls have been tilting in favor of an exit, our base case remains that the U.K. will vote to remain with the EU.
- Since it is difficult to gain an edge in calling the outcome of the vote, our portfolio managers remain heavily focused on ensuring that risk is appropriately managed in Bessemer portfolios, and a number of scenarios are being planned for so that they will be able to take advantage of investment opportunities as they arise.

With the results of the Brexit referendum just one week away, the political climate in the U.K. and, consequently, volatility in markets have been intensifying. We have discussed the issues at length in the recent commentaries *A Briefing on Brexit: Evaluating the Risks of the U.K. Leaving the EU* and *A Conversation on Brexit* (video). Additionally, the expectation that Brexit would trigger a decline in the market's appetite for risk is one reason why we increased our exposure to high-quality fixed income in our asset allocation shift in early May (see *Building Our Defenses*). In this piece, we provide a brief update on our views in light of recent developments. We plan to release a video on Friday, June 24, following the final Brexit vote, highlighting the results and any further implications for Bessemer portfolios.

Tighter Polls, Market Volatility, and a Tragic Event

Our base case remains that the U.K. will vote to remain with the EU, but recent polls have shown a growing share of voters favoring an exit. There are a slew of polls, all of which have inherent biases, such as being dependent on results collected via the internet (biased toward younger voters, who tend to favor "remain") or phone (biased toward older voters, who tend to favor "leave"). One way of looking at cumulative information is to monitor bookmaker odds, which have shown an increase among those intending to vote for an exit from 20% to 40% in recent weeks. Market proxies of U.K. risk have been trading in line with these probabilities, and sterling (GBP) is 3.6% weaker versus the U.S. dollar this year. U.K. equities are underperforming the U.S. by over 5% year to date (S&P 500 up 2.8% vs. FTSE 100 down 2.5% total return in local currency).

The shift in polls and headline events may actually start to steer voters back to the status quo of remaining in the EU. Polls suggesting an increased chance of Brexit may motivate cautious voters who are afraid of the consequences of leaving the EU to make the effort to vote next week. This dynamic seems to have been relevant during the referendum in Scotland on remaining in the U.K., when actual results were highly in favor of remaining, contrasting with polls ahead of the vote.

On Thursday, June 16, Jo Cox, a Labour member of Parliament who was in favor of remaining in the EU, was murdered while attending to constituency business in West Yorkshire. She was not a high-profile member of Parliament, but she was highly respected, and all campaigning on the referendum has been suspended until Saturday. Although the tragedy was in all likelihood a completely isolated incident, the gunman reportedly yelled "Britain First" at the time of the shooting. Britain First is the name of a far-right group that campaigns against immigration and multiculturalism in the U.K. The organization has quickly distanced itself from any connection to the tragedy, but it is possible that Ms. Cox's death may temper the emotional turn the campaign has taken or bring more awareness of her arguments for remaining in the EU.

A vote in favor of Brexit would surely trigger significant market volatility. Broker dealers are already citing concerns regarding liquidity in the latter half of next week, and it is likely that GBP and U.K. equities would suffer significantly in a Brexit outcome. We would estimate that GBP could fall an additional 10%. As we discussed in our piece earlier this year, the implications are very important for Europe at large, both given the U.K.'s role as a financial intermediary in the region, but also because the U.K. leaving could set the precedent for other independence movements to take hold elsewhere (i.e., Catalonia). More generally, global equities would suffer on the uncertainty of what a Europe without the U.K. would look like; U.S. equities could experience losses in the mid-single digits in the immediate aftermath. Conversely, there would likely be a relief rally across equity markets in the event the "remain" camp wins.

Political Responses and Implications

The potential political aftermath of the referendum is also getting interesting. George Osborne, Chancellor of the Exchequer, has floated the idea of an emergency post-Brexit budget which would include income-tax increases and spending cuts to fill a potential £30 billion hole in public finances resulting from Brexit. Given that it is unlikely that such a budget would pass with the necessary number of votes, this would create additional political and economic uncertainty.

In the event of Brexit, it is likely that U.K. Prime Minister David Cameron would remain in office for a few weeks, at best. Even in the case of the U.K. remaining in the EU, some political commentators are speculating that Cameron will have to leave to help heal the rifts within the Conservative Party. Potential replacements for Cameron could include Michael Gove or Boris Johnson (in the case of a "leave" vote) or Theresa May (in the case of "remain").

Bessemer Thoughts and Positioning

The uncertainty surrounding the Brexit vote was a risk factor we highlighted in our recent asset allocation shift to reduce our fixed income underweight. In a Balanced Growth portfolio, our U.K. equity exposure is a small component (around 3%) and is significantly underweight versus the benchmark. Within our U.K. exposure, we are more heavily weighted toward large-cap stocks, which are more insulated from Brexit risk given that their revenue streams are multinational and well diversified. Since it is difficult to gain an edge in calling the outcome of the vote, our portfolio managers remain heavily focused on ensuring that risk is appropriately managed in Bessemer portfolios. A number of scenarios are being planned for so that they are able to take advantage of investment opportunities as they arise.

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Brexit: A Conversation with Holly MacDonald and Alex Lloyd (May 2016)

"R & R" — Quarterly Investment Perspective (Second Quarter 2016, **Video Available**)

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