Questions about Brexit

There are many questions that one can ask about Brexit and unfortunately the vast majority of those that we were asking ourselves in March, last time we wrote about Brexit, remain unanswered. Then, as now, there were limited days left until the deadline and then, as now, there was no way of seeing for certain what the outcome would be. Some things have changed. We have a new Prime Minister in the UK and new presidents of the European Council and Commission. The resurgence of the Liberal Democrats and the emergence of the Brexit Party in the EU elections have both the main political parties looking nervously over their shoulders. Regrettably, these factors have only added more questions to the already extensive list.

Perhaps the most important question for our clients though, and the one we get asked most often is, how will Brexit affect my portfolio. If opinions vary widely on what the overall political conclusion may be in the next few months, it is nothing compared to the range of economic outcomes possible for the various companies under our coverage, depending on the details of that result.

Even measuring the overall “Brexit exposure” of a portfolio can be difficult. Although London listed companies make up 20% - 35% of the portfolios, it is the actual economic exposure that will determine the impact on the company and therefore the share price. For example, Imperial Brands, although listed in London, has just 14% of its revenue exposure in the UK. We judge that the effect of a weak pound on Imperial’s earnings will far outweigh any potential impact from Brexit. And Imperial is not alone in this. Similar situations can be found across the large multinationals making up the FTSE 100. Moreover, even when a company has significant earnings exposure to the UK, for example Meggitt or Merlin Entertainments, it remains difficult to estimate the overall impact on the company. Many of Meggitt’s products are priced in dollars and so the company will likely see a positive currency impact. For Merlin, a weak pound encourages “stay-cations” and provides a boost to foreign tourism, benefiting UK attractions.

Therefore, at Credo, we don’t position our portfolios in such a way that requires us to have an opinion on the outcome of macroeconomic events. We recognise where our strengths lie, and it is not in predicting the results of such proceedings. What we can do instead is to examine the potential downside as well as upside for each of the individual stocks in our portfolio. Both in a worst-case Brexit scenario and also, should the outcome be better than currently feared. We can examine the risk and potential reward presented in the case of each individual company and its share price. Indeed, since the announcement of the referendum, when examining a new investment idea with UK earnings exposure, these questions have become a core part of our process. We also consider how that risk and reward balance fits in with the rest of the companies in the portfolio. We have refrained from buying companies where an investment thesis is based upon a binary Brexit outcome, for example, the UK housebuilders or banks.

We are comfortable that the portfolios are positioned in such a way that, in any Brexit scenario, our investors are not likely to see an outsized negative impact. We believe that the majority of companies in which we are invested will be able to deliver earnings growth over the long term, whatever the outcome of the political process.

We, like many of our investors, look forward to the time when some of the current questions become answerable. We may not be able to tell you when that will be, or what the likely results are, but what we can tell you is that, no one knows. In the mean-time we will continue to aim to invest in quality companies at attractive valuations, with a long-term horizon and take advantage of the opportunities that the market presents.

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