Multi-Asset

Risk and reward: Finding the perfect balance

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Just when investors thought it safe to re-enter the water, the surprise Brexit referendum outcome brought significant volatility and renewed uncertainty about growth, policy and geo-politics. While the immediate ramifications were felt hardest in the UK and Europe (especially in currency markets where the sterling slumped and in financial stocks), away from Europe the ramifications were more benign. While this is in large part because Brexit has its most direct effects on the UK and the UK economy (we think a recession in the UK is now highly likely), the more muted stance in other assets can be at least in part attributed to the pressure Brexit puts on central banks in general to continue to pile stimulus into the global economy. The "bad news is good" mentality is alive and well.

Janet Yellen and the Fed had already turned more dovish with further US rate hikes seemingly requiring a combination of a run of strong data (especially payrolls), rising inflation, rising asset prices and stability in key global economies – all at the same time - an unlikely combination at the best of times. Meanwhile, the ECB whose focus remains on headline (not core) inflation will continue to push harder into negative rate territory irrespective of the risks this poses for European banks in particular and for the pricing of risk assets more broadly. It is certainly fair to conclude that Brexit will pose some downside risks to growth in Europe, but it is doubtful that throwing more fuel on the fire will help.

While we, like most of the market, were surprised by the Brexit result, the impact of this on the portfolio has been modest.

In broad terms, the Real Return Strategy has been defensively positioned. This is reflected in low absolute exposure to equities (28%) and relatively high exposure to cash (27%). We had little direct exposure to UK equities and sterling. For the residual of the portfolio which is mainly in credit based assets and mainly high grade and high quality, exposure to the UK and Europe is relatively small. While we did add risk to the portfolio in February following the sharp declines in equities and the significant widening in credit spreads, as risk assets recovered more recently, we took action to again reduce risk through firstly trimming our global high yield debt exposure, but more significantly, by adding a 5% US S&P put option position which in the event of a sharp fall in equities would effectively reduce our equity exposure by an equivalent 5%. While the reverberations from Brexit were relatively narrow and concentrated in UK / European assets, exposure to volatility and having some broad based protection has been beneficial, especially given our downside risk focus.

While markets have in many cases recovered from their Brexit jitters, we are remaining cautious. There is still significant uncertainty surrounding the consequences and timeframe of the eventual exit of Britain from the EU. Likewise, we are sceptical of the sustainability of the recovery in risk assets which seems in large part premised on more central bank support rather than improving underlying fundamentals. In fact, some significant question marks hang over US profits and whether the moderation we’ve seen recently proves temporary.
One thing Brexit has done is remind us about the inherent vulnerability of financial markets to these sorts of shocks. Our approach is anchored to the idea that the ability of markets to withstand these shocks is a function of valuations (cheap assets are in a much better position than expensive assets) and in the ability of policy makers to provide support. The caution we describe above reflects both these ideas. Cheap assets are non-existent (and some much more vulnerable than others) and the ability of policy makers to deal with a crisis is arguably reaching a limit (debt levels are tapping out and interest rates are already very low / negative). This makes markets vulnerable.

It also means that what we’ve seen recently in terms of heightened volatility and strengthening headwinds will become more evident going forward. Steering a steady course through this, and taking advantage of these episodic dislocations will be important as we balance our return objectives against our risk objectives – particularly the avoidance of significant downside risk.

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