Heartwood
Investment Management

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Investment Insight

Weekly Insight

How are we positioned ahead of the Brexit vote?

The Brexit vote is less than two weeks away, the margin of error remains tight and, whatever the outcome, this debate is revealing more uncertainties about the course of further European Union integration and British domestic politics. Markets are largely expecting that an 'In' vote would lead to a short-term relief rally, while an 'Out' vote would be seen as more of a shock.

Our tactical investment decisions over the last few months have been shaped by global considerations, rather than in response to any one single event, such as Brexit. However, Brexit comes at a time when we have to recognise that there are more uncertainties in the world and, as the year has progressed, our portfolios have been increasingly positioned to reflect our more cautious view. The overall growth trajectory remains stable, which has been helped by reduced headline risks around China and a rebound in the oil price, but it is arguably less secure than in previous years. Brexit, central bank exhaustion, the US election cycle and the extension of the bull cycle are all factors that could lead to economic disequilibrium.

So how should investors respond?

We believe that the current environment demands a greater focus on risk management, capital preservation and portfolio diversification. Our central case remains of a benign global macroeconomic backdrop and range-bound markets, but we have to acknowledge that downside risks have increased. In light of upcoming events, including Brexit, we have incrementally reduced overall risk levels within portfolios in the last few months:

- We continue to believe that **equities** will deliver more compelling risk-adjsuted returns over the medium term. However, this will be an environment for active and flexible investors, as we expect to see greater dispersion by sector, style and geography. We have reduced our overall allocation to equities, though maintaining a modest overweight. From a style perspective, we have a value tilt in recognition that growth stocks' valuations may prove difficult to justify without a turnaround in the current earnings backdrop. We are also edging higher our weighting in emerging market equities within our higher growth strategies, as these markets are positioned for long-term growth opportunities.

- In terms of our UK equity market allocation, we maintain an underweight position, holding a higher weighting in large-cap equities, which are heavily skewed to energy and miners and, in aggregate, are beneficiaries of a weaker sterling. We continue to believe that domestically-exposed small- and mid-cap stocks could see more pressure on the basis of the economic uncertainty presented by a Brexit outcome, as well as higher import costs due to a weaker sterling. On other side of the Brexit question, we could see significant market falls in European equities in the event of an 'out' vote, notwithstanding likely dispersions between sectors and countries. Inevitably, periphery countries would most likely absorb the brunt of a risk-off trade. However, sterling investors would be cushioned by a weaker UK currency. Furthermore, it is worth mentioning that global investors, which have been reducing their allocation to the region over the past three months, may be attracted back on a valuation basis.

- In **bonds,** we are keeping duration short in UK and US government markets, but will take the opportunity to add to our market weighting should yields rise from current levels, given that global interest rates are likely to stay historically low. In the event of a 'Brexit' scenario, UK gilts are likely to find a safe-haven bid initially. However, this will not necessarily be a one-way trade, given worries about capital flight, a softer near-term growth outlook and a weaker sterling, which may foster inflationary pressures in the future, as well as impact the funding of the UK's sizeable current account deficit.

- We are underweight **commodities**, though are taking advantage of a recovering oil price through our US high yield bond exposure. We have also introduced a modest position in gold in some of our strategies, as it provides a diversified return stream and we believe prices would benefit from the theme of 'central bank exhaustion', as well as more general risk aversion.

- Brexit concerns continue to be the primary driver of investment activity in **UK commercial property** in the first half of this year, with all major sectors seeing lower investment volume levels. First quarter 2016 performance returns for the IPD Index were the lowest since 2012. We maintain selective exposure to the sector, preferring to hold exposure to regional offices and industrials, due to low vacancy rates and rental growth. We retain a positive outlook on these areas of the market where supply pressures should continue to drive positive rental growth and yield compression. In the event of ‘Brexit’, and if we were to see a meaningful sell off in the UK currency, we would potentially add to our property exposure.

- We have reduced overall **currency** risk in anticipation of increased foreign exchange volatility as headline risk events build.

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